ARGENTINA IN MERCOSUR DURING 1990s

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CERTIFICATE

Certified that the dissertation entitled **"ARGENTINA IN MERCOSUR DURING 1990s"** submitted by me in partial fulfillment of the requirements for the award of the degree of **Master of Philosophy** has not been previously submitted for any other degree to this or any other university and is my own work.

Akash Chandra Sahoo
Signature of the Student

We recommend that this dissertation may be placed before the examiners for evaluation.

25/04/05

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DEDICATED TO
MY FAMILY

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PREFACE

Unarguably the rapid spread of regionalism is the most important recent development in the global trading system. In the globalisation era, recent literature on regional integration has stressed the key role that emerging trading blocs are likely to play in shaping the world economy of the 21^{st} century. With the end of the Cold War and the eventual dismantling of the Soviet Union, Latin America witnessed some radical economic and political changes. So policymakers have refocussed their attention on economic issues. Economic variables such as-high trade volumes, capital flows, massive technology transfers and R & D have assumed new importance.

As a regional economic grouping, the *Mercosur (Mercado Commun del sur*) was created by Argentina, Brazil, Paraguay and Uruguay in March 1991 with the signing of the Treaty of Asuncion. It originally was set up with the goal of creating a common market among the participating countries on the basis of various forms of economic cooperation arrangements that had been taking place between Argentina and Brazil since 1986. These two countries played a dominant role in the establishment of Mercosur.

The present study is a modest attempt to understand and analyse the Argentine position, and its role in Mercosur from its inception. Chapter I i.e. introduction deals with the historical analysis of resurgence of regionalism during 1990s and its impact on the developing nations of Latin America. It focuses on the establishment of Mercosur from the signing of the Montevideo Treaty in 1960 to the Asuncion Treaty in 1991. Social, political and economic factors behind the formation of Regional Trading Blocs are also analysed in detail along with the basic objectives and institutional framework of Mercosur.

Chapter II, titled 'Mercosur : Policy Issues and Performance' focuses on industrial policies which deal with particularly Mercosur's most important industry- the automotive industry. It also highlights the implementation of Asuncion Treaty provisions, which include tariff liberalisation and common external tariff. Trade expansion under Mercosur is analysed with the perspective of Argentina. The last section explains the capital inflows into Mercosur members as a result of impact of the creation of the free trade area.

Chapter III, titled 'Argentina in Mercosur' narrates Argentina's trade and investment linkages with Mercosur with special emphasis on Argentina's trade policies and objectives. Some issues of common external tariff and investment are analysed in detail taking into account Argentina's position. The last part highlights Mercosur's relationship with European Union, much talked South American Free Trade Agreement and Free Trade Area of Americas. It also deals with Argentina's role and position for further enhancement of its relation with European Union.

Chapter IV, titled 'Argentine Economic Crisis and its Effects on Mercosur', presents an overall summary of the recent economic crisis in Argentina during 20001-02. An effort is made to understand the nature, causes and response to the crisis situation. While doing so, the chapter focuses on the repercussion of the crisis on Mercosur.

Chapter V, attempts Summary and Main Conclusions of the dissertation.

CHAPTER I

INTRODUCTION

The 1980s witnessed not only the end of the Cold War and the eventual dismantling of the Soviet Union, but also radical political and economic changes across Latin America. While in 1980s authoritarian rule was the norm in most countries in the region, by the end of that decade it had been replaced by some form of constitutional democracy in each of them. For example, military rule in Argentina and Brazil ended in 1983 and 1985 respectively, and these two former adversaries began the process of moving towards political accord with closer economic engagement. The concept of 'globalization' came to mean many things, but for developing regions such as Latin America it was seen both as an opportunity, to come in from the periphery through integrating into a developing global economy, and a challenge, of how to achieve that integration. The response was to embrace the 'new (open) regionalism' and the neoliberal economic model personified by the 'Washington Consensus': trade liberalization and open markets, privatization, liberalization of investment flows, deregulation, fiscal discipline and so on.

RESURGENCE OF REGIONALISM

The rapid spread of regionalism is surely the most important recent development in the global trade system. Recent literature on regional integration has stressed the key role that emerging trading blocs will have in shaping the world economy of the 21st century. With the end of the Cold War, policymakers have refocussed their attention on economic issues. Economic trends – such as rapid changes in research, technology, capital flow, and trade patterns have assumed new importance. Increasing competition in world markets has induced industrialized countries to cluster together in regional economic blocs.[1] This has been the case with the European Community (EC), the North American Free Trade Agreement (NAFTA), and possibly Japan and East Asian neighbours.[2] However, these experiments in regional integration differ appreciably in nature. For instance, the EC explicitly seeks an economic and political union, whereas the NAFTA is simply a free trade area whose goal is the eventual elimination of restrictions on investment flows.[3] Here it is to discuss about the importance of Europe & North America as the facts of recent regionalism.

RECENT REGIONALISM: THE FACTS

Spreading regionalism is on the world policy agenda because many respected thinkers fear that it could kill the proverbial gold-laying goose-the world trading system. The fear-inducing regionalism, however, does not consist of the Andean trade group, the East African Economic Community, or other similar arrangement. Members of such clubs are economically small, account for very little of the world's trade and have more frequently been free-riders than supporters during GATT Rounds. North Atlantic regionalism is an entirely different matter.

European and North American regional arrangements directly govern 40 per cent of world trade, and their members account for half of world income. These agreements affect trade with non-member nations, so it is important that two-thirds of world trade is with North Atlantic nations that have discriminatory deals with their main commercial partners. Furthermore, these North Atlantic

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[1] During the late 1980s, the world economy moved increasingly toward regional policies.
[2] NAFTA consists of USA, Canada and Mexico.
[3] A preferential trade arrangement (PTA) occurs when groups of countries place lower restrictions (tariffs, quotas, non-quantitative restrictions) on trade with each other than on trade with the outside world.

nations have been the traditional stalwarts of the WTO/GATT. Plainly, the goose is in trouble if regionalism greatly weakens Europeans' and Americans' support of multilateralism. It is therefore paramount to understand their recent interest in regionalism.

The EU's Single Market programme is a deep integration agreement. In principle, it means that member states cannot restrict imports of EU goods or services at the border (all border measures including anti-dumping and countervailing duties are excluded), or by means of domestic health, safety and environmental standards (standards are mutually recognized). Nor can they restrict intra-EU capital and labour movements, or inhibit establishment of firms from EU nations. Member states cannot freely choose their state-aids policy, competition policy, or indirect taxation rates. All these restrictions are supervised by the supranational European Commission and can be enforced by the supranational European Court of Justice. Lastly, nations joining the prospective monetary union will no longer control their monetary policy.

Here North American Free Trade Agreement is worth discussing. NAFTA will eliminate most tariffs and many non-tariff barriers on US-Mexico and Canada-Mexico trade in 10 to 15 years. It liberaises many investment restrictions among the three, and taken together, the investment component of NAFTA goes beyond those agreed in the Uruguay Round.[4] Trade in financial and telecommunications services is also partially liberlisd. Finally, NAFTA is not a customs union.

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[4] Baldwin E. Richard, 'The Causes of Regionalism', '*World Economy*', 20 (5) August 1997, pp. 871.

REGIONAL INTEGRATION IN LATIN AMERICA

In Latin America, NAFTA stimulated a series of overlapping bilateral and plurilateral agreements in the Hemisphere. For instance, Mexico singed FTAs with Chile, Caricom (a Caribbean Trade Group), Venezuela, Costa Rica and Bolivia, Chile singed similar FTAs and the Andean Pact (Venezuela, Colombia, Ecuador, Peru and Bolivia) was renewed.

Growing integration-through unilateral liberalization, adherence to multilateral codes, and regional trade arrangements (RTAs)- has been, with macroeconomic adjustment and the redefinition of the role of the state, one of the pillars of Latin America economic reforms.[5]

In keeping with this trend, four countries of South America-Argentina, Brazil, Paraguay, and Uruguay-joined together to create the Common Market of South America (*Mercado Comun del Sur,* or MERCOSUR) in March 1991, the most ambitious attempt yet toward regional integration in Latin America. MERCOSUR represents what might be termed the "great leap forward" approach to integration.

FACTORS BEHIND THE FORMATION OF REGIONAL TRADING BLOCKS

'Open regionalism' represents an effort to resolve one of the central problems of contemporary trade policy: how to achieve compatibility between the explosion of regional trading arrangements[6] around the world and the global trading systems as embodied in the Word Trade Organization. The concept seeks

[5] Mercosur at Seven: Goals, Achievements, and outlook, A Seminar Paper, *'Economia Internationale'*, 51 (3), 1998, August pp. 349.

[6] Over 60 per cent of world trade takes place within regional arrangements that have either achieved free trade or have pledged to do so.

to assure that regional agreements will in practice be building blocks for further global liberalization rather than stumbling blocks that deter such progress.[7] Southern Cone regionalism in the 1990s was tightly bound up with the responses of South American governments to the challenges of the globalizing world economy, and with the associated process of neoliberal restructuring which were in full flight in most countries. The adoption of 'open regionalism, was seen as a direct reflection of the policy imperatives generated by globalization processes, and as such regional integration constituted an attempt on the part of the member countries to improve their competitive positions in the world economy both individually and as a bloc. For much of the 1990s, in this sense, Southern Cone regionalism approximated a type of 'mesoglobalization',[8] which featured a 'bottom-up' process of integration consistent with the objective of increasingly deep engagement with the process of globalization.[9] Apart from facilitating trade liberalization open regionalism was designed to enhance the potential for countries to attract foreign direct investment, as a result of the lure of larger markets to multinational corporations eager to take advantage of economies of scale. In addition, regional integration – involving the relocation of decision – making authority and a consequent contraction in space for discretionary government policy-was of particular utility in providing an escape valve against the political pressures fanned by the impact of neoliberal policies on, for example, formerly protected or uncompetitive industries, public sector employees and

[7] Bergsten C. Fred, Open Regionalism, '*World Economy*' 20 (5) August 1997, pp. 545.
[8] N. Phillips, "The Future of The Political Economy of Latin America" in *Political Economy and the Changing Global Order*, R. Stubbs and G.R.D. Underhill (eds), Ontario; Oxford University Press, 2000, p. 286.
[9] D. Tussie, 'In the Whirlwind of Globalization and Multilateralism: The Case of Emerging Regionalism in Latin America' in *Regionalism and Global Economic Integration: Europe, Asia and the Americas*, W.D. Coleman and GRD Underhill (eds.), London: Routledge, 1998, p. 92.

unskilled workers.[10] The dynamics of regionalism in the 1990s were thus informed by a perceived need to 'lock in' a particular neoliberal orientation and to respond to the exigencies of globalization: in this sense, sub-regionalism can be seen to be as much about domestic political economy (the national capitalist project) as it was about a 'new international political economy' at the regional and global levels.

POLITICS BEFORE ECONOMICS

This spirit of economic cooperation and quest for mutual gains did not emerge in a vacuum. In great measure, it arose as a consequence of the tremendous political changes that swept the region during the 1980s. During the Southern Cone's bout with bureaucratic authoritarianism in the 1970s and early 1980s, tensions between neighbours ran high. Argentina and Chile were perennial rivals and nearly went to war in 1978 over disputed claims to islands in the Beagle Channel. For centuries, Argentina and Brazil had competed for regional domination and had often clashed over boundaries and water rights. But with the transition towards democratic government, first in Argentina in 1983, then Brazil in 1985, and finally Chile in 1990, relations changed.[11]

Argentina and Brazil launched vigorous diplomatic efforts to improve their relations, initially not in the realm of economics but in nuclear power. Rivalry had been particularly pronounced in this area, these being the only countries in Latin America with atomic capacity.[12] A move by one from the production of energy to

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[10] P. Bowles, 'Regionalism and Development After (?) the Global Financial Crises', *New Political Economy,* 5 (3), 2000, p. 439.
[11] Berlin David Pion, in Will Soldiers Follow? Economic Integration and Regional Security in the Southern Cone, *'Journal of Interamerican Studies and World Affairs'*.42 (1), 2000, spring. Pp. 43-69.
[12] Ibid., p. 45.

the production of nuclear arms would deal the other a decisive military disadvantage. Mutual distrust was aggravated by a lack of transparency in diplomatic relations, characterized by a complete absence of informational exchanges, reciprocal visitation, or controls (Hirst and Trvares 1988; Solingen 1996; Barletta 1998). With the return to democracy, a vigorous diplomatic effort was launched from the nuclear "platform," beginning with the Foz de Iguazu Declaration of November 1985, which committed both nations to develop nuclear power for peaceful used only. Furthermore, they were to make their nuclear energy policies compatible, exchange information, visit each other's sites, and create mechanisms of compliance and enforcement.

The significance of these accords reached well beyond the nuclear issue. Through the process of diplomatic negotiation, Argentina and Brazil began to break down the political and psychological barriers which had separated them for so long. This paved the way for other kinds of bilateral and multilateral understandings. Economically, it set the stage for the talks that would result in the creation of MERCOSUR.

Mercosur should be analysed against this background in terms of the logic of advancement of domestic project in Brazil and Argentina aimed at reorienting social relations in those countries and imposing the discipline of capital over labor-or, in broad terms, at exposing those societies to the global logic of capital.[13] In specific terms, the objective was to bring the economies and societies of the region into line with an emerging regional pattern, a goal given a sense of urgency and common purpose as a consequence of shared perception that considerable ground had already been lost to regional competitors such as Chile and Mexico. In

[13] Cammack Paul in Mercosur and Latin American Integration, '*the Japanese Economy*, vol. 29, No. 4, July – August 2001, pp. 59.

this context, the inclusion of Paraguay and Uruguay barely affected what was essentially a bilateral arrangement. It was a particular feature of the regional context that domestic projects of economic and social restructuring were being taken forward in the precarious context of a simultaneous efforts to restore liberal democratic political systems.[14] All in all, then, Mercosur was as much about creating and securing a particular kind of domestic social and political order as about establishing state positions in an emerging world order. Engagement in the subregional project, in short, has been intended to advance and reinforce emergent national political projects whose principal goal is to achieve bourgeois hegemony and relative state autonomy at the domestic level, and specifically to transform social relations in order to embed a neoliberal domestic order which it is possible to reproduce through liberal democratic political institutions: in this sense, the creation of the subregional association can be seen as an extension of domestic political economy.[15]

The key aspect of the regional context here was the final disappearance of the conditions for statist developmental projects (based on import-substitution) as a result of the debt crisis of the 1980s. This was made critical by the relative backwardness of both domestic adjustment and political institutionalization in Argentina and Brazil. These two countries had made little progress in restructuring their economies by 1990, and their processes of transition to democracy remained precarious and only weakly institutionalized. The genesis and consolidation of Mercousr coincided in time with the adoption of programs of neoliberal restructuring in Brazil in 1990 (under President Fernando Collor de Mello) and in Argentina in 1991 (under President Carlos Saul Menem), against

[14] Ibid, pp. 59.
[15] P. Cammack, "Mercosur; From Domestic Concerns to Regional Influence," pp. 96-97.

the background of repeated failures in the recent past. Framework agreements with other Latin American states including the Mercosur were designed "to set out and enforce new economic and political 'rules of the 'game' in the hemisphere," reflecting "*the triumph of economic liberalism, of faith in export-led growth and of belief in the centrality of the private sector to the development process.*

ESTABLISHMENT OF MERCOSUR

Historical Background

The first step towards regional integration in Latin America, the signing of the Montevideo treaty in 1960, came only a short while after the creation of the European Coal and Steel Community (1951) and the European Economic Community (1957). The Latin American Free Trade Association (ALALC) provided for the creation of a free-trade zone, by means of periodical and selective negotiations between member states. This choice-negotiation at the discretion of the member states, rather than automatic reduction of import duties – allowed the trade opening programme to develop reasonably well in its first years, but progresses lost impetus as of 1965, and came to an almost complete standstill in the 1970s. ALALC was replaced in 1980 by the Latin American Integration Association (ALADI), a loose association of 11 Latin American countries with a flexible mandate to establish, in a gradual and progressive manner, a common market. The most ambitious attempt at sub-regional integration has been the Andean Pact, established in 1969 between Bolivia, Chile, Colombia, Ecuador, Peru, and Venezuela.[16] While the Agreement envisaged the setting up of a Common External Tariff (CET), its intention was to a large extent limited to

[16] Venezuela actually joined the Pact in 1973, while Chile exited in 1976.

widen protected markets, maintaining and even raising barriers against the rest of the world in an ultimately-doomed effort to make import-substitution work better. In sum, in the past integration was dominated by the desire to avoid challenging the interests of protected groups in the participating countries and led, at most, to a reduction of protections on non-competing imports.

FROM UNILATERAL LIBERALIZATION TO THE ASUNCION TREATY

In the second half of the 1980s, at the inception of the trade reforms, all Mercosur countries were characterized by high tariffs and foreign exchange restrictions, moreover, Argentina and Brazil maintained stringent quantitative restrictions on both imports and exports. With all Latin American countries facing widening external imbalances, derived from insufficient competitiveness on the global market as well as from worsening terms of trade, reforms have pursued a greater neutrality of trade incentives in parallel with a reduction and tariffication of quantitative restrictions. In Argentina, liberalization started slowly in 1989, accelerating dramatically over the following two years. By 1994, the maximum tariff had dropped from 50 to 22 per cent, reaching an average unweighted legal tariff of about 15 per cent. Nontariff barriers (NTBs) have been almost completely eliminated, persisting only in the car industry (where quotas and a special regime apply) and, for security or environmental reasons, on a few other products such as pharmaceuticals, foodstuffs, and defense materials. Brazil followed a similar schedule, with reforms starting under the Collor administration (1990-92) and receiving a full backing during Fernando Henrique Cardoso's tenure as Finance minister in the early 1990s. Trade reforms have been accompanied by liberalizing changes in Brazilian laws, including the elimination of the concept of "Brazilian company of national capital" and the opening of a number of strategic areas to private and foreign participation. The average applied tariff dropped from 21.2 per cent in January 1992 to 14 per cent in July 1993 and now stands at 12.5 per cent (WTO, 1996). Tariff dispersion and escalation were also reduced.

Under the ALADI system, Argentina and Brazil signed the Declaration of Iguacu in 1985 and one year later created the Programme of Economic Integration ad Co-operation (PICE), which soon received increasing attention in business circles, mainly in Argentina. In 1988, Argentina and Brazil signed a Treaty for Integration, Cooperation and Development that set the stage for a common market between the two countries within ten years. It was further established that this agreement would be open to all other Latin American countries. After the adhesion of Paraguay and Uruguay,[17] a new treaty was singed on 26 March 1991 in Asuncion, providing for the creation of a common market by 1 January 1995.

OBJECTIVES AND INSTITUTIONAL FRAMEWORK

Objectives

Mercosur initially targeted a free-trade zone, then a customs union, and, finally, a common market. Its four main objectives are:

1. to allow the free circulation of production goods, services and factors between the member states by eliminating customs duties and lifting NTBs;.

[17] Uruguay had singed bilateral economic co-operation agreements in 1975 both with Argentina and Brazil.

2. to fix a CET and adopt a common trade policy with regard to third parties and to coordinate positions in regional and international commercial and economic meetings;
3. to coordinate macroeconomic and sectorical policies of member states relating to foreign trade, agriculture, industry, taxes, monetary system, exchange and capital, services, customs, transport and communications in order to ensure free competition; and
4. to commit the member states to make the necessary adjustments to their laws to allow for the strengthening of the integration process.

In addition to the reciprocity doctrine, the Asuncion Treaty also contains provisions regarding the most-favored-nation (MFN) clause, allowing members to automatically extend-after actual formation of the common market to the other Treaty signatories any advantage, favor, entitlement, immunity, or privilege granted to a product originating from non-ALADI countries. Last, but certainly not least in a context historically marked by the frequency of political upheavals, the Treaty considers democracy as a necessary requisite for economic integration.

Institutional Structure

The Asuncion Treaty was updated by the 1994 Protocol of Ouro Preto, which has given Mercosur an international legal status, allowing it to negotiate with other countries and supranational bodies. Mercosur is a union of nation states, with a minimum of supranational institutions (Table1), and decision taken by consensus.

Table 1 – The Institution of Mercosur

Body	Composition	Responsibilities
Common Market Council	Minister of Foreign Affairs and the Economy (or the equivalent)	Governing body and legal representative, presided by each country in rotating alphabetical order for 6 month periods.
Common Market Group (CMG)	16 member representing the Ministries of Foreign Affairs and the Economy and the central banks	Executive body, meeting every three months. Its basic duties are to cause compliance with the Asuncion Treaty and to take resolutions required for implementation of the decisions made by the Council. Furthermore, it can initiate practical measures for trade opening, co-ordination of macroeconomic policies, and negotiation of agreements with third parties.
Trade Commission	Government officials	Assists the CMG, deciding common trade policies, and submitting proposals regarding regulation of the areas under its authority. It can propose a change in the import duty on specific items under CETs, including cases referring todevelopment of new Mercosur production activities.
Sub – groups	Government officials	Communications; mining; technical rules; financial matters; agriculture; energy; labour and social security; health.
Socio-economic Advisory Forum	Business community	Advisory body, with powers to submit proposals.
Joint Parliamentary Committee	Members of Parliament	Advisory body, with powers to submit proposals.
Secretariat		Administrative body and official archive, established in 1996 in Montevideo.

While Mercosur is small compared to the EU (1995 GDP $ 8,398 billion) or NAFTA ($7,771 billion), its territory comprises 70 per cent of the total land mass of South America, the combined population of the four member countries is 206 million, and its 1995 total GDP of $ 995 billion is 1.4 times China's, or 2.9 times Russia's. This experience is thus of interest under three main aspects. First, as an element in the wider framework of structural policies underway in developing reforms; second, because it allows to assess the road taken by economic integration in Latin America, a region that in the past pursued integration as an extension of other inward-looking economic policies; and, third as a showcase of the gains deriving form "new regionalism".

CHAPTER – II

MERCOSUR: POLICY ISSUES AND PERFORMANCE

Comprising a major share of Latin American population, land and regional income, the Southern Cone Common Market (Mercosur) represents a serious attempt at economic integration in that region. Initiated by the Treaty of Asuncion in 1991, Mercosur aims to eliminate all internal tariff and non-tariff barriers on the flow of goods and factors of production, implement a common external tariff, and harmonise numerous macroeconomic and sectoral policies among Argentina, Brazil, Paraguay and Uruguay. More broadly, Mercosur is evolving into a core unit with which other countries and regional trading blocs can negotiate trade arrangements. Already agreements have been signed admitting Chile and Bolivia as associate members, and negotiations are taking place with the *Pacto Andino* countries and the European Union. Thus, Mercosur is engaged in simultaneous efforts to widen its membership and to deepen integration among its members.

The difficulty of this task is demonstrated by the fact that despite more than two dozen attempts at regional integration in the world over the past four decades, only the European Union has successfully forged the path from free trade area, to customs union, to common market, and now towards monetary union.[1] The EU's experience has shown that the predicted welfare gains from integration do not result automatically from tariff reduction alone, but rather depend on the removal of other barriers to competition.[2]

Indeed, one of the principal objectives of Mercosur is precisely to exploit potential welfare benefits from an economy-wide programme of reform and market liberalisation. By broadening the scope of liberalisation to an economy-wide free-trade area for goods and services, embedded in a lowering of common

[1] A free trade agreement (FTA) is one which removes all barriers to trade in goods among member countries while each member maintains its individual tariffs *vis-a-vis* non-member countries.
[2] In some cases these predicted gains can be quite large. Estimated static gains from the creation of the European Union range from two to six per cent of GDP.

external tariffs, Mercosur explicitly seeks to deliver greater competition and efficiency through 'open regionalisation'. Closely tied to efforts to maximise welfare and promote open regionalism is the issue of industrial policy. Broadly defined, industrial policies encompass the combined effect of government policies designed to affect the allocation of resources among economic activities and produce an outcome different from what otherwise would have occurred in the market.[3]

MERCOSUR ISSUES AND PERFORMANCE

Theory and Policy Issues

Theory provides strong underpinnings for the proposition that unilateral and multilateral liberalisation are the best policies for an individual or group of countries to follow, at least in terms of static economic comparative advantage. Unfortunately, theory is much less clear about the impact of regional trade arrangements (RTAs), in part because of the typically ambiguous results of second-best welfare economies, and in part because proponents of regional trade agreements in particular often point to dynamic effects which are difficult to capture.

From a static perspective, the impact of Regional Trade Agreements (RTAs) is usually analyzed by considering the effects of trade creation and trade diversion. Typically, it is argued that if trade creation dominates trade diversion,

[3] Such policies could include tax exemptions or reductions for specific industries, selective credit schemes, concessional loans or administered trade protection measures such as anti-dumping measures and countervailing duties.

then the welfare of the members of an RTA may rise.[4] The crucial issue, then, is under what conditions will trade creation most likely outweigh trade diversion? Theory points to two factors. First, the higher the initial trade between two countries, the less likely it is that there will be sizable diversion due to regional preferences. It is presumed that initial trade already indicates global comparative advantage and so regional preferences do not result in switching purchases to less efficient producers. Second, the lower the external tariffs, the lower the likelihood of trade diversion.

Mercosur, however, is driven by the two giants of Latin America – Argentina and Brazil – and consequently there is little reason to give much credibility to the dynamic arguments rather than to other issues. The political economy effects, perhaps more pertinent at this early phase of Mercosur's development, might affect those purely economic considerations.[5]

The first issue is that of membership. The widening of group membership bolsters the objective of providing a coordinated body for negotiating with the other groups. Rapid expansion, therefore, can have its benefits. On the other hand, the larger the number of countries, the harder it becomes to harmonise the pace of liberalisations. The tendency will be to move at a pace which all members can easily accommodate. Provided that Mercosur continues to be associated with lower external barriers, the elimination of sectoral exemptions, membership expansion, and rapid growth of internal and external trade, it will be welfare enhancing and a stepping stone to greater openness in the region. Mercosur is negotiating with non-member countries as an institutionalized group. One case is

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[4] Leipziger, M Danny, Frischtak Claudio, Kharas Homi J. and Normand John F in "Mercosur: Integration and Industrial Policy", *The World Economy*, vol. 20, No. 5, August 1997, p. 589.
[5] It is worth recalling that Mercosur issues largely fall under the Ministries of Foreign Affairs, and presenting common political objectives is expressly stated as a goal.

Chile. Chile's full membership in Mercosur is hindered, however, by the differentials and dispersion of the Mercosur Common External Tariff (CET), which contrasts with Chile's flat rate tariff of 11 per cent. Other countries that are considering the possibility of joining Mercosur include Bolivia, Colombia, Ecuador, Peru, and Venezuela; agreements with all these countries could make Mercosur the basis of a free trade zone encompassing virtually all of South America.

The second issue is how to specifically implement the Treaty. Mercosur does not define any financing mechanism for regional development, industrial restructuring or reconversion initiatives, or joint research and development projects. Further, Mercosur's institutional arrangements are far weaker than those in the EU, which coordinate and enforce policy through supranational entities such as the European Parliament and the Court of Justice. Mercosur's inter-governmental Working Groups do not enjoy such legal autonomy or budgetary powers. Finally, the Treaty of Asuncion's provisions for the harmonisation of monetary, tax and industrial policies do not specify proper timetables and implementation mechanisms for achieving these goals. This ambiguity is neither unintentional nor necessarily undesirable at this stage; the range of policies to be harmonised and the number of constituencies involved is sufficiently broad and complex that member countries interests may be better served by specifying only the broadest objectives and allowing Mercosur's intergovernmental working groups to negotiate the terms of eventual policy harmonisation.

The third issue is the extent to which adjustment will stimulate backpeddling. Already, Brazil introduced some non-tariff barriers and Argentina reinstated the 'statistical tax' which was really a three per cent tariff. Indeed, both

Brazil and Argentina have found it increasingly difficult to grow rapidly without balance of payments pressures emerging. Both countries, although to different degrees, have eschewed the use of exchange rate policy to improve external competitiveness. Instead, they have attempted to bolster export growth by stressing the importance of reducing other costs to tradable goods producers through infrastructure development, financial system changes, and the alleviation of regulatory burdens. The result is that improvements in aggregate GDP growth can worsen trade deficits. While these pressures have been manageable to date, thanks to sizeable capital inflows, there is concern that such policies cannot be sustained over the medium-term. Once two key determinants of external capital flows (high domestic interest rates and significant privatisation opportunities) return to normal levels, the issue of trade deficits will become more critical. Both Brazil and Argentina have shown, in the recent past, a tendency to use trade interventions with the rest of the world and even with Mercosur partners as an instrument for managing balance of payments problems.

The final issue is how to deal with sectoral interests in the context of a customs union or common market. Many programmes that are important for national purposes, such as regional, sectoral, and small and medium enterprise development, social security and government procurement, have important implications for the location of foreign and local investment and trade. As region-wide protection levels come down, the flexibility of the government to deal explicitly with hard domestic issues will also be reduced. Developing a new set of understanding as to how to handle these choices will be critical. Yet their unique problems, varying economic and political systems and weak common institutional structures will likely complicate any mutually agreeable technical solutions. In this environment, political commitment to maintain the momentum of Mercosur will become even more important as a basis on which compromise solutions can be found.

INDUSTRIAL POLICIES IN MERCOSUR

Historical Aspects of Industrial Policy

Broadly defined, industrial policies encompass any state acts or policies designed to affect the allocation of resources among economic activities and alter what would otherwise have been the market outcome. This definition is quite broad and can include sector-specific interventions, industry-specific interventions, or those applicable to all industries i.e., functional interventions. Regardless of their national particularities, industrial policy instruments can be grouped under the rubric of trade, tax and credit policies.[6]

For several reasons, industrial policy constitutes an obvious area for Mercosur's attention both during these early phases of trade liberalisation and throughout the entire integration process. Nonetheless, care has to be taken to mitigate the adverse effects of industrial policy on the progress of integration in the region. For one thing, selective industrial assistance programmes which distort relative prices will lead to resource misallocation and a loss of economic efficiency. Second, industrial policies introduce an additional complex political element since they provide a popular remedy for import-competing firms reluctant to adjust to trade liberalisation. Finally, integration may inspire competition among governments to outspend one another in order to confer a competitive

[6] Some examples of trade policies include selective duty rebates and non-uniform tariffs, non-tariff barriers ranging from outright QRs to more subtle protection such as product labelling and packaging requirements, safety standards, administered protection such as anti-dumping measures and countervailing duties, and differential rules of origin or domestic content requirements.

advantage on domestic industries. Any positive benefit conferred by state aid in one country may be cancelled out by countervailing measure in another, leading to a squandering of resources. These reasons illustrate the fact that industrial policy is a powerful tool which could significantly affect the welfare outcomes of Mercosur. Thus, a common approach to industrial policy is necessary in order to (i) maximise potential gains from integration, (ii) provide clear rules of the game for governments in dealing with inevitable pressures for state aid in one form or another, and (iii) prevent actions, and reactions, which in the end may jeopardise Mercosur's success.

Some Industrial Policies

To put Mercosur industrial policy in perspective, a review of industrial policies in Brazil and Argentina yields the overall conclusion that industrial policy interventions are on the whole relatively modest in both countries. Three examples of industrial policy in Mercosur are export promotion policies, regional development policies and automotive policies.

Both Brazil and Argentina have been pursuing export promotion programmes which should boost long-run Mercosur-wide exports. The Brazilian export promotion programme consists of two key mechanisms: fiscal incentives (in the form of tax exemptions) and finance. Regarding Argentina's export promotion policies Argentina In 1992, extended preferential duties to any industry group which agreed to set export targets. This plan, called the Industrial Specialisation Regime, was aimed at facilitating the productive restructuring of firms producing manufactured goods. Under the programme participating firms are required to increase their exports over those made in previous year in exchange for tariff preferences. The programme, although intended to meet the laudable goal of expanding exports, engenders several economic costs: foregone fiscal revenue which was estimated at $46 million in 1996, it subsidises an activity which may have occurred even in the absence of a government programme, it subsidies firms which should be willing to undertake the necessary restructuring and retooling in order to enter those export markets anyway, imposes a complex balancing requirement on imports and exports within a given sector in order for firms to quality for special tariff exemptions and embodies an implied discretion in approving industries for participation in the regime and penalising firms which do not comply with their previously committed export quotas.

Both Brazil and Argentina have also been pursuing programmes which target the development of certain regions. In Argentina, legislation authorises provincial governments to provide incentives for regional economic development in the country's poorest provinces. Most programmes operate in San Luis, La Rioja, San Juan and Catamarca and offer one or a combination of the following incentives: exemption, reduction, suspension or deferment of national level taxes, accelerated depreciation, and duty free capital goods imports. In 1993, the fiscal cost of such programmes was estimated at approximately $1.54 billion. The establishment of free trade zones (with Tierra del Fuego being an important one) also seeks to promote regional development. The Ministry of Interior estimated the value of these fiscal concessions at $226 million in 1994.

The third example is that of one of Mercosur's most important industries- the automotive industry. The liberalisation of automobile imports in March 1990 had multiple impacts: it led to a fall in prices and the rapid expansion of domestic production, it brought about higher quality models allowed by more flexible domestic content rules, it stimulated competitive behaviour in an industry accustomed to quasi-cartelised conduct, and it attracted new entrants (including Renault, Mercedes-Benz, as well as Kia Motors. and Asian Motors, among other South Korean automakers). Subsectoral trade is growing considerably, and reached US$ 1.14 billion in 1994 (including autoparts)- with Brazilian exports to the Mercosur reaching US$765.4 billion and Brazilian imports US$375.4 billion. In particular, the industry has been the major factor in the rising proportion of intra-industry trade between Argentina and Brazil. The intra-industry trade coefficient for the two countries reached 39 per cent of total trade for 1993, 51.3 per cent for manufacturing trade and 77.3 per cent in the case of the automotive industry.[7]

While the scale of Mercosur industrial policy is relatively modest, much work needs to be done to rationalise Mercosur's industrial policies in a better way.

IMPLEMENTATION OF ASUNCION TREATY PROVISIONS

Mercosur has widely been viewed as an important example of the "new regionalism". Past Latin American integration schemes had been designed to expand the size of protected markets for import-substitution industrialisation. "New" or "open" regional integration schemes are seen as tools to enable the countries involved to participate more effectively in the economic and political processes associated with globalisation.[8] They arose as Latin American countries, in many cases with newly established or restored democracies, had embarked on

[7] The Intra-industry trade coefficient reflects the proportion of intra-industry trade within a particular segment relative to total trade volume in that segment.

[8] Bulmer-Thomas, Victor ed., Regional Integration in Latin America and the Caribbean: the Political Economy of Open Regionalism. Institute of Latin American Studies, London, 2001.

sweeping free-market economic reforms in which the dismantling of barriers to foreign trade and investment occupied a central role.

The origin of Mercosur lies in bilateral co-operation agreements signed by the newly democratic governments of Argentina and Brazil in the 1980s. Both countries then embarked on unilateral trade liberalisation. The Treaty of Asuncion reflected that change. It contemplated the complete liberalisation of trade in goods between the countries, and proclaimed Mercosur's ambition to become an EU-style common market in which labour as well as services, goods and capital would move freely. Relations with the rest of the world would be conducted through a common external tariff (CET) and a common foreign trade policy.

Article 5 of the Asuncion Treaty defined a path of tariff liberalization to achieve zero internal tariffs and the elimination of nontariff barriers by the end of 1994. The immediate reduction of the internal applied tariff rates was by 47 percent of the most favoured nation (MFN) rate after the ratification of the Treaty. Subsequent preferential reductions relative to prevailing MFN rates were to occur semi-annually and automatically according to the following time table: 54 percent by December 1991, 61 percent by June 1992, 68 percent by December 1992, 75 percent by June 1993, 82 percent by December 1993, 89 percent by June 1994, and finally 100 percent by December 1994.[9] Members were allowed to declare up to 300 exceptions to internal free trade, but by 1995 approximately 95 percent of intraregional trade was duty-free.[10] In fact, Brazil had only 27 exceptions and so effectively had open borders for its Mercosur partners.

Mercosur members had originally planned to align their external tariffs on its common external tariff by January 1, 1995, However, this did not achieve the

[9] Article 3, Annex 1, Trade Liberalization Programme, Treaty of Asuncion, 1991.
[10] Laird, Sam. "Mercosur: Objectives and Achievements". Mimeo, World Trade Organization, June 1997.

expected goal properly and little progress was made in defining the CET until the Protocol of Ouro Preto was signed in December 1994. Under the Ouro Preto Protocol, the CET was to be introduced from the beginning of 1995. Each member was again allowed an exceptions list, the tariffs on which were to be aligned by 2001 for Argentina and Brazil, and 2006 for Paraguay and Uruguay.[11] Brazil included approximately 200 tariff lines in the exceptions list, mainly sensitive industries such as computers, electronics, chemical, agro-industry, textiles, capital goods (machinery), and the automotive industry.

Following by these negotiated changes, Unilateral liberalization, reduced tariffs substantially in Mercosur countries, i.e. from an average of 50 percent in1988 to a CET average of 12 percent in 1995. However, in order to meet short-un political objectives, trade policy in Brazil was subject to vigorous debate and to frequent changes. For example, tariffs on textiles, toys, and motor vehicles in particular were increased to 70 percent for non-members in 1995.[12] The different phasing of internal and external tariff rates, and the use of exceptions mean that over 1989-1996 tariffs and preference margins varied widely over time and commodities.[13]

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[11] Olarreaga, Marcelo and Soloaga, Isidro. "Endogenous Tariff Formation: The Case of Mercosur". *World Bank Economic Review*, May 1998, 12 (2), pp. 297-320.

[12] Motor vehicles have always been a special issue within Brazil. Coupled with the 70 percent tariffs, the Brazilian government applied special local content rules, under which firms that produced vehicles locally were given reduced rates of 35 percent. These rules (and similar ones in Argentina) prompted several multinationals to set up automobile plants within the Mercosur region.

[13] Chang Won and Winters L. Alan, "How Regional Blocs Affect Excluded Countries: The Price Effects of Mercosur" in *American Economic Review*, 92 (4), 2002, Sep. , pp. 889-904.

TRADE EXPANSION UNDER MERCOSUR

The contribution of general trade liberalisation and deeper liberalisation within Mercosur has led to rapid trade expansion. Available data indicate that the trade patterns of member countries have changed significantly since the formation of Mercosur. For example, Table 1 provides summary statistics on Mercosur's intratrade and on exports to destinations such as the countries in the OECD (Organization for Economic Cooperation and Development), NAFTA or OECD. These data are shown for selected periods from 1979-81 to 1994 in order to help determine when the trend changed. This is sufficient to identify the effects of preferential trade policies. Some preferences were included in the Argentina-Brazil sectoral agreements at the end of the 1980s, and widespread preferences were introduced in the transition period for Mercosur starting in June 1991.

Table 1 mainly covers three-year period in order to reduce the influence of any annual erratic trends in trade statistics, such as those that might be accompanied by significant fluctuations in commodity prices. Data for 1993 and 1994 are shown separately in order to reflect the recent influence of Mercosur on trade flows. A more detailed analysis of the annual trade data used in the construction of Table 1 strongly suggests that 1991 was the year in which intratrade became significantly more important. In June 1991 Mercosur began to implement discriminatory tariff preferences on intratrade.

The figures reported in Table 1 show the increasing importance of Mercosur markets for all four member countries. For example, in 1984-86 less than 10 percent of Argentine exports went to Mercosur compared with 30 percent by 1994. Although the 1984-86 level was lower (about 5 percent), a threefold increase also occurred for Brazil's exports to Mercosur (almost 14 percent in

1994), while Uruguay's share of exports rose almost 20 percentage points, reaching almost 47 percent in 1994. For all member countries taken together, the 1994 share of exports to Mercosur (reaching 20 percent) was almost three times the corresponding 1984-86 level.

Further Table 1 reveals two key trends in the direction of Mercosur's exports over the last decade: intra-Mercosur trade became significantly more important at the expense of trade with countries in NAFTA, which remained stable or declined slightly, and of trade with Europe, which declined. Available data on member countries' imports also reflect the major increase in the relative importance of trade between Mercosur's members. From 1984-86 to 1994 the share of imports originating in member countries rose from 11 to 20 percent. The reorientation of Mercosur's trade toward member countries over this full interval, or during the 1990s, was far greater than that in any other regional arrangement, including the European Union, the Association of Southeast Asian Nations, and the Canadian-United States Free Trade Arrangement.

Table 1

Trade Destinations of Mercosur 1979-81 to 1994

Exporter	World (millions of dollars)	Percentage of total exports					
		OECD	NAFTA	United States	Europe	Non-OECD counties	Mercosur
Argentina							
1979-81	8,322.7	45.0	11.4	8.7	32.5	55.0	13.4
1984-86	7,785.2	44.9	14.4	11.2	28.3	55.1	9.5
1990-92	12,187.1	49.5	14.5	11.7	33.3	50.5	16.8
1993	13,114.4	43.6	11.9	9.7	29.3	56.3	28.1
1994	15,803.3	40.2	13.1	10.9	25.6	59.3	30.4
Brazil							
1979-81	19,556.3	58.2	21.6	18.0	32.7	41.8	8.1
1984-86	25,008.6	64.7	29.8	27.2	29.1	35.3	4.7
1990-92	32,987.8	63.6	25.2	21.4	32.8	36.4	7.8
1993	38,679.4	56.1	24.5	20.7	27.6	43.9	13.9
1994	43,355.2	57.4	24.2	20.6	29.0	42.6	13.7
Paraguay							
1979-81	303.6	52.7	6.6	5.7	41.3	47.3	38.4
1984-86	290.3	48.8	3.7	3.6	43.7	51.2	36.3
1990-92	784.1	41.9	5.0	4.7	36.8	58.1	37.6
1993	725.2	45.8	8.2	7.3	38.0	54.2	39.6
1994	816.8	36.3	7.6	7.0	29.1	63.7	52.0
Uruguay							
1979-81	1,021.0	44.0	9.8	8.5	33.6	56.0	30.6
1984-86	953.3	41.7	14.9	13.5	25.1	58.3	28.4
1990-92	1,629.9	38.8	13.1	10.1	26.4	61.2	34.7
1993	1,603.3	32.6	12.3	9.2	21.9	67.3	41.2
1994	1,918.1	30.4	10.1	6.8	21.7	69.6	46.7
Mercosur							
1979-81	29,203.6	53.9	18.2	14.9	32.7	46.1	10.7
1984-86	34,037.4	59.5	25.6	23.0	28.9	40.6	6.7
1990-92	47,588.9	58.8	21.7	18.3	32.8	41.2	11.5
1993	54,122.2	52.2	20.9	17.6	28.0	47.8	18.5
1994	61,893.3	51.8	20.7	17.5	27.9	48.1	19.5

Source : Compiled from United Nations Comtrade records.

During the five years between 1990 and 1995, trade between the four nations has increased dramatically, especially for Brazil and Argentina. The following data in Table-2 indicate the trade patterns among the countries.

Table 2

Exporting Countries	Importing Countries	Average Annual Percent Increase between 1990-1995
Brazil	Argentina	44
	Paraguay	28
	Uruguay	22
Argentina	Brazil	32
	Paraguay	35
	Uruguay	18
Paraguay	Brazil	8
	Argentina	8
	Uruguay	0
Uruguay	Brazil	7
	Argentina	27
	Paraguay	33

Source : The Economist, 12th October, 1997- Mercosur Survey p. 6.

The early years of Mercosur witnessed intra-block trade boom. Total intra-Mercosur imports rose from $4.1 billion in 1990 to $20.7 billion in 1997. Thereafter, as first Brazil and then Argentina ran into macro-economic problems, trade stagnated and then fell back: intra- Mercosur exports totalled $17.6 billion in 2000. According to a preliminary estimate, they fell further in 2001, to $16 billion. Mercosur's imports from third countries followed broadly similar trends (IDB, 2001). Total imports for the Mercosur countries rose from $27.4 billion in 1990 to $99 billion in 1997 before declining to $86.7 billion in 2000.

In fact, there has been some managed trade between Argentina and Brazil, such as the auto agreement between the two countries and Brazil's decision to switch its purchases of oil and wheat to Argentina. Although these arrangements form part of Mercosur as an overall project, they fall outside its trade rules. Despite these exceptions, and despite the upward movement in the average external tariff, hitherto Mercosur clearly meets the definition of "open regionalism". Nevertheless, there are some important differences in the kind of products that the Mercosur members trade with each other compared with their exports as a whole. Mercosur provides an especially important market for its members' manufactured exports, those with a higher technological content, and those from small and medium enterprises.[14]

INVESTMENT PROJECTS

The impact of the creation of Mercosur has also been reflected in the increasing flow of intraregional investments. Macroeconomic stability in Argentina, together with the strong economic growth seen in the last four years in this country, has created incentives for both investors in the subregion and multinational corporations. In response to the opportunities afforded by a larger economic market, multinational corporations have formed partnerships with entrepreneurs in the subregion or have set up subsidiaries in a broad range of production and commercial sectors. In the automotive sector, for example, there have been complementary production agreements and other arrangements to encourage specialization. In the areas of food, textiles, plastics and construction materials, partnership agreements have been reached between Brazilian and Argentine producers. The abundant supply of energy in Paraguay has attracted investment in the chemical sector. There has also been increased growth in services, including investment in tourism in Uruguay and Brazil, the establishment of branches of foreign banks in Montevideo and Buenos Aires, and the interest shown by Chilean investors in insurance and reinsurance. To a large extent, the increased flow of investments to the subregion can be attributed to privatization

[14] Reid, Michael, "Remapping South America: A Survey of Mercosur", The Economist, 12, October 1996.

programs and greater liberalization in these countries, but the reduction of barriers to foreign investment has also played a significant role.[15]

The share of Mercosur member countries in world foreign direct investment (FDI) inflows increased from 1.4% in 1984-89 to 5.9% in 1997-99. This share is much higher than that exhibited by Mercosur in terms of world GNP (below 4%) or trade (nearly 1.5%). Hence, it seems that one of the main assets of this new trade agreement has been its capacity to attract FDI.

As a result, transnational corporations (TNCs)[16] have become the most dynamic agents in these economies-most notably in Argentina and Brazil-displacing state enterprises (which have mostly been privatised in both countries) and, to a lesser extent, large domestic conglomerates.[17]

The increasing share of services in FDI inflow is explained not only by the privatisation of utilities and other state companies, but also by: (1) sectoral deregulation and/or lifting of previous FDI entry barriers in areas such as banking and insurance; (2) the increasing importance of private supply in health and education; (3) the changes in the pension systems; (4) the fall of the share of the manufacturing industry in the GDP of Mercosur countries *vis a vis* services sectors.[18]

As a logical consequence of the massive arrival of FDI to the economies of the region, the presence of TNCs in those economies increased strongly in the 1990s. Between 1990 and 1998, the share of foreign affiliates in sales increased from 34 to 59% in Argentina (considering the 1,000 largest firms), from 41 to

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[15] http://www.itcilo.it/actrav/actrav/actrav-english/telearn/global/ilo/blokit/mercor.htm

[16] TNCs, are firms that have made outward direct investments, irrespectively of the number of affiliates.

[17] It is interesting to take into account that most domestic conglomerates that survived TNCs massive expansion in the 1990s became increasingly transnationalised themselves.

[18] Chudnovsky Daniel and Lopez Andres, in "Transnational Corporations' Strategies and Foreign Trade Patterns in Mercosur Countries in the 1990s" , *Cambridge Journal of Economics* 2004, vol. 28 (3), pp. 635-652.

51% in Brazil (considering the 500 largest private firms), from 36 to 51% in Paraguay (considering total sales) and from 26 to 38% in Uruguay (considering 300 largest firms).[19,20] The same trend is observed when other economic variables such as valued added, investment and employment are analysed. In this way, Argentina and Brazil have reached very high levels of TNC presence, only comparable with those found in some East Asian countries which are wide open to foreign investment such as Malaysia and Singapore.

TNCs have also increased their share in foreign trade flows. While in 1990 TNCs' affiliates absorbed 32% of total exports in Argentina, their share reached 54% in 1998. In Uruguay, the TNCs' share passed from 26% to 30% between 1992 and 1998, in Paraguay from 32% to 54% in the same period and in Brazil from 48% to 53% in 1989-97.[21] We find a similar trend in the case of imports. TNCs increased their share in imports from 62% to 72% in Argentina, from 53% to 63% in Brazil, from 6% to 11% in Paraguay and from 22% to 24% in Uruguay.[22]

IDB COOPERATION WITH MERCOSUR

The Bank is supporting the integration process among the four countries through a technical cooperation project approved in January 1993. The overall

[19] Only non-financial firms were considered in all cases, except for Paraguay. It is worth noting that foreign presence in the banking system has significantly increased in the four countries.
[20] The sales of the 1,000 largest firms in Argentina represented 49% of GDP in 1998. In Brazil, the 500 largest firms represented 40% of Brazilian GDP in 1997, while the corresponding figure in Uruguay for 1998 was 59%.
[21] In the case of Argentina, the figures were estimated for the 1,000 largest exporters, which amounted to 90% of total exports in 1998. In Brazil, the data were obtained from a sample of the 500 largest firms, which contributed with nearly half total exports in 1997. Both in Paraguay and Uruguay, the figures are based on data from the country's total exports.
[22] The basis and time periods for these estimates are the same as those used for export share estimates in Brazil, Paraguay and Uruguay. In the case of Argentina, the 1,000 largest importers were taken into account, which amounted to 63% of the country's total imports in 1998. The time period considered in this case was 1995-98.

objective is to help implement and launch Mercosur by providing the technical support needed by the countries, especially in coordinating and/or harmonizing macroeconomic and sector policies.

In the area of sector coordination, there was an assessment of agricultural and agro industrial competitiveness and another on the competitiveness of the industrial sector (both at the Mercosur level), and studies on comparative energy systems, including the institutional and legal aspects of the electricity and hydrocarbons sectors and an analysis of energy impact on selected production sectors. In terms of macroeconomic policy harmonization, there are reports on exchange parities, comparative analyses for reconciliation of tax systems and for coordination of rules on the free movement of workers. The Bank is considering an application for a new technical-cooperation designed to advance the process of integration and support production and technology reconversion in the private sector, principally for small and medium-sized enterprises.

CHAPTER – III

ARGENTINA IN MERCOSUR

The creation of Mercosur in 1991 can be viewed both in a historical context and as an adaptation to the contemporary political climate.[1] While some argue that it has a historical lineage that can be traced back to independence,[2] others see its genesis as a relatively recent phenomenon.[3] Some countries of that region promoted the idea of a customs union in the 1930s and 1950s. By 1960, the Latin American Free Trade Association (LAFTA) had been created; but by the end of that decade it had stalled, with rising discord among members. Many countries had also adopted 'Import Substitution Industrialization' (ISI) policies involving extensive protectionism. But during the intervening period, various developments contributed to the subsequent cooperation agreements of the 1990s. These included the desire to escape the so-called 'Lost-Decade' of the 1980s, when debt spiralled and countries defaulted; the return to democratic institutions and the opening of the economies to international trade and investment; the end of the Cold War, offering closer relations with the Untied States[4] and the trend towards economic regionalism in Europe and North America.

The key to the emergence of Mercosur, however, was the steady development of closer relations between Argentina and Brazil from the mid-1980s as both returned to democracy and began economic liberalization.[5] Indeed, Almeida suggests that Mercosur was essentially a side effect of a political

[1] Meliss H. Birch, 'Mercosur: the Road to Economic Integration in the Southern Cone'. *International Journal of Public Administration*, vol. 23, No. 5, May-Aug. 2000, p. 1404.
[2] Sylvia M. Williams, 'Integration in South America: the Mercosur Experience', *International Relations* vol.13, No.2, Aug. 1996, pp. 51-61.
[3] Felix Pena, 'New Approaches to Economic Integration in the Southern Cone', *Washington Quarterly* vol. 18, No.3, Summer 1995, pp. 113-22.
[4] Jeffrey Cason, 'On the road to Southern Cone Economic Integration', *Journal of Interamerican Studies and World Affairs*, vol. 42, No. 1, 2000, pp. 23, 25.
[5] Daniel Chudnovsky and Fernando Porto, 'On Argentina – Brazilian Economic Integration', *CEPAL Review* vol. 39, 1989, pp. 115-34.

decision by both countries rapidly to enhance bilateral integration,[6] although Cason is more specific in arguing that it was 'driven by the strategy and needs of Brazil'.[7] In December 1986, the two countries signed an Act of Friendship, Democracy, Peace and Development, seeking to end the traditional rivalry between them, and further developments were consolidated in the 1990 Act of Buenos Aires. Shortly afterwards, negotiations began which resulted, by March 1991, in the Treaty of Asuncion, providing for a Common Market of the South – Mercosur - within four years, and including Paraguay and Uruguay. A key objective 'economic development with social justice' in the region. At the heart of Mercosur were two important principles: the idea of open regionalism; and the political significance of Mercosur as 'a joint proposal for the shared development of these South American nations'.

Progress in Mercosur has been somewhat uneven since its creation, and presently it has been beset by the political and economic crisis in Argentina. This has in turn a devastating effect on the small members as well as exacerbated structural weaknesses in Brazil. Nonetheless one early success was reflected in expansion of trade among members. Despite the partial success of Mercosur, conflicts between the partners have been a regular phenomenon.

TRADE AND INVESTMENT LINKAGES WITH MERCOSUR

Argentina's Trade Policy

Since the first Trade Policy Review (1992), Argentina has deepened the structural reform programme, begun at the end of the 1980s, particularly in the

[6] Paulo Roberto de Almeida, 'Mercosur's Future in the Context of Multilateral and Regional trade Liberalization', Workshop Paper, at http://www/cap/uni-muenchen./de/transatlantic/events/la.html.
[7] Cason, 'On the road to Southern Cone Economic Integration', p.24.

area of trade liberalization and openness. The programme to reduce tariffs and eliminate barriers to trade launched in 1998 was given a strong push forward by the current administration, both unilaterally and through different regional and multilateral negotiations, fully consistent with the obligations deriving from membership of the World Trade Organisation (WTO).

One of the keys to the process of growth described above was the sharp increase in foreign trade volumes. Between 1990 and 1997, Argentine exports of goods doubled in value (from US$12.3 billion to US$25.5 billion) marking an average annual growth of 10.9 per cent (far higher than the 6.7 per cent rate of growth in world trade). On the other hand, imports grew from US$4.1 billion in 1990 to US$30.4 billion in 1997-ranking Argentina among the countries that have experienced the largest rise in imports in recent years.[8]

Since 1991, Mercosur has developed an important role in international negotiations. Based on that recognition, Mercosur has gradually and progressively become a reference point for the South American countries. Surmounting the inevitable difficulties implicit in the integration process, Mercosur, through a well-understood concept of regionalism, is one of the main tools that other countries can use to address the challenges of a globalized economy. By way of example, trade flows between the member countries have grown fivefold thus far in this decade and economic agents now see the regional market as a permanent and strategic reality. These developments constitute one of the key factors in attracting investments. Mercosur's imports from outside the zone have grown rapidly as well.

[8] *WTO Press Communique*, No. 98- Appendix- Table 2).

Opening up Argentine economy to foreign direct investment (FDI) has been another pillar of the reform. Capital inflows quadrupled between 1990 and 1997, turning Argentina into one of the main recipients of FDI among the developing counties. By the end of 1996, accumulated foreign direct investment flows (1990 to 1996) amounted to more than US$22.4 billion, making Argentina the third largest recipient of FDI among the developing nations, after Malaysia and Mexico. Although the privatization process explained a large part of those flows in the early years of the decade, the completion of the bulk of the process (around 1993/1994) did not lead to a drop in foreign investment. On the contrary, the flows acquired new impetus and it was generally agreed that in the coming years their relative importance in the national economy will grow even more.

Trade Policy Objectives

Argentina's trade policy includes an autonomous process of liberalization, participation in regional integration under Mercosur and active and full participation in the multilateral trading system.

The core trade policy objective is integration of the national economy with the world economy. To that end, the opening up and liberalization of import and export trade and the treatment of foreign investment have been and continued to be the pivotal elements in the period under review. Liberalization of the economy is a component of the structural reforms that were deepened and consolidated under the Convertibility Plan. This liberalization consisted essentially the elimination of all barriers or obstacles to exports and imports of goods and services, coupled with the free entry and exit of foreign capital. The restructuring of the industrial enterprises that was promoted under the Argentina's structural reform was intended to provide the country with the capacity to compete at the global and regional levels.

However liberalization had begun at the end of the 1980s, with a unilateral reduction in import duties and the gradual elimination of different mechanisms that directly or indirectly hampered import and export operations. In 1991, through application of Decree 2284/91 on economic deregulation in particular, a number of instruments for state intervention in foreign trade which constituted non-tariff barriers to imports and exports were eliminated.[9] Consistent with this process of autonomous liberalization, major steps were taken toward subregional integration under Mercosur. The integration process that began in 1991 was strengthened with the signing of the Ouro Preto Protocol in December 1994 and the introduction of the customs union. Mercosur signed trade agreements with Chile and Bolivia and began negotiations with the Andean Community. Mercosur also signed a framework agreement with the European Union. It is participating actively in building the FTAA and is attempting to forge close ties with other geographic areas, particularly South-East Asia, which will be discussed later in this chapter.

Reaffirmation of the full consistency of Argentina's trade policy with the rules of the multilateral trading system is essential for assuring that the country's economy will be able to integrate into the world market without contradictions or backtracking.

Trade Flows

Between 1990 and 1998 intra-Mercosur's trade increased fivefold-from US$8 billion to US$41 billion (Table 1). This was equivalent to a rise in the share

[9] http"//www.wto.org/english/tratop_e/tpr_e/tp100_e.htm

of Mercosur's total world trade from 11 per cent to 23 per cent during the same period. The aggregate data, however, disguise variations among individual member states. For example, Argentina's intra-Mercosur trade in 2000 was 30 per cent of world trade, whereas for Brazil it was only 14 per cent against 26 percent with the European Union. Less developed country such as Paraguay was the most dependent on its Mercosur partners, with which it conducted 54 per cent of its total trade.

Table 1

Mercosur trade, 1990-1999 (US$ million)

	1990	1996	1997	1998	1999
Trade with world	73,800	158,428	182,465	177,147	154,354
Intra-Mercosur	8,230	34,148	41,466	41.405	31,394
% of total trade	11.2	21.6	22.7	23.4	20.3
Trade with US	15,146	28,567	32,815	32,843	30,987
% of total trade	20.5	18.0	18.0	18.5	20.1
Trade with EU	20,290	40,018	45,118	46,555	41,891
% of total trade	27.5	25.3	24.7	26.3	27.1

Source: CEI (Centre For International Economics): http://www.mercosur.com.

Table 2 shows the increasing importance of the Mercosur market for its member countries, the share of zonal trade rising considerably for all importers and exporters alike. Intra-group exchanges as a share of total trade by member countries have risen considerably in 1991-96, from 13.08 per cent (despite a fall in 1995 in the Maxican crisis). Nonetheless, it still amounts to less than 2 per cent of Mercosur's GDP, compared with 4.5 per cent for NAFTA and 14 per cent for the EU. Moreover, at $ 6,380 million, Argentine-Brazilian trade in 1995 would have ranked twenty-eighth relative to the 55 bilateral trade flows in EU-12, roughly at the same level as trade between Denmark and the United Kingdom.[10]

[10] Goldstein, A, "Mercosur at Seven: Goals, Achievements, And Outlook", *Economia Internationale*, vo. 51, No.3, Aug. 1998, pp.349-82.

Table 2

Some Basic Indicators of Intra-Mercosur Trade (% share)

	% share of Mercosur, 1991		% share of Mercosur, 1997	
	Exports	Imports	Exports	Imports
Argentina	16.51	21.00	36.18	23.57
Brazil	7.30	10.53	15.60	14.90
Paraguay	34.46	33.10	57.33	41.95
Uruguay	34.70	40.07	45.51	46.19

Source: IMF, Direction of Trade Statistics Yearbook. (various issues)

Bilateral trade balances have shown a relatively high level of variations, as it can be expected given unsynchronized business cycles and fluctuating exchange rates. A very simple measure is provided by the frequency with which they have changed sign (e.g., the Brazil-Paraguay balance passing from a Brazilian deficit to a Brazilian surplus the following year). In 1991-95, there are 30 bilateral balances (Table 3), 24 possible comparisons, and in 5 cases (21 per cent) there was a change in sign. For the EU-12, the same indicator shows a much greater stability: over the same period, there were 275 bilateral balances, 220 year-on-year comparisons, and 18 changes of sign (8 per cent).

Table 3
Mercosur's Bilateral Trade Balance ($ million)

	1991	1992	1993	1994	1995	1996	1997 (Jan-June)
Argentina-Brazil	-43	-1,668	-754	-631	990	1088	778
Argentina-Paraguay	138	207	285	426	581	402	242
Argentina-Uruguay	145	33	-59	-139	325	426	183
Brazil-Paraguay	273	356	686	702	787	719	355
Brazil-Uruguay	-109	173	335	163	75	-214	-103
Paraguay-Uruguay	1	0	-4	-9	-17	-26	-11

Source: IMF, Direction of Trade Statistics Yearbook. (various issues)

Trade between Brazil and Argentina represents two thirds of all intra-Mercosur exchanges. Suffice here to highlight some general trends (Table 4). Goods being traded can be clustered in four broad classes: consumer goods (food, beverages and tobacco, textiles), intermediate manufactured goods (chemicals, iron and steel, paper and cellulose), capital goods (transport and electromechanical equipment), finally, primary goods (agricultural products and meat, mining products).

Table 4

Trade between Brazil and Argentina

	1994		1995		1996		1997 (Jan-Jun)	
	US$ mn	% of total	US$ mn	% of total	US$ mn	% of total	US$ mn	% of total
Agriculture produces and met	1440	18.47	2002	20.78	2284	19.11	1342	19.39
from Brazil	168	4.07	170	7.39	316	6.11	223	7.49
from Argentina	1272	34.72	1832	32.77	1968	29.02	1119	28.39
Electro-mechanical equipment	1063	16.63	1227	12.74	1516	12.68	861	12.44
from Brazil	817	19.75	762	18.85	1056	20.12	558	18.73
from Argentina	246	6.72	465	8.31	460	6.78	303	7.69
Chemical products	846	10.85	1168	12.13	1320	11.04	705	1019
from Brazil	614	14.85	801	19.83	842	16.29	480	16.11
from Argentina	232	6.34	367	6.57	478	7.04	245	6.22
Food, beverages and tobacco	263	3.37	369	3.83	415	3.47	278	4.02
from Brazil	198	4.78	187	4.63	203	3.92	156	5.24
from Argentina	65	1.77	182	3.25	212	3.13	122	3.10
Iron and steel	497	6.37	556	5.77	589	4.93	367	5.30
from Brazil	460	11.13	476	11.78	489	9.46	304	10.20
from Argentina	37	1.02	80	1.44	100	1.47	63	1.60
Mining products	820	10.52	999	1.037	1434	12.00	807	11.66
from Brazil	201	4.85	166	4.11	187	3.61	77	2.58
from Argentina	619	16.91	833	14.91	1247	18.38	730	18.52
Paper and cellulose	195	2.50	316	3.28	360	3.01	202	292
from Brazil	180	4.34	220	5.44	251	4.86	135	4.53
from Argentina	15	0.41	96	1.71	109	1.60	67	1.70
Textiles	371	4.76	471	4.89	693	5.80	330	4.77
from Brazil	176	4.26	177	4.39	279	5.40	160	5.37
from Argentina	195	5.31	294	5.27	414	6.11	170	4.31
Transport equipment	1069	13.71	1807	18.76	2636	22.05	1661	24.00
from Brazil	1000	24.18	781	19.33	1261	24.39	762	25.58
from Argentina	669	18.27	1026	18.35	1365	20.13	889	22.56
Other goods	634	8.13	717	7.44	715	5.98	357	5.16
from Brazil	322	6.80	301	7.45	286	5.54	124	4.16
from Argentina	312	8.51	416	7.43	429	6.33	233	5.91
Total	7798	100.00	9632	100.00	11952	100.00	6920	100.00
from Brazil	4136	100.00	4041	100.00	5170	100.00	2979	100.00
from Argentina	3662	100.00	5591	100.00	6782	100.00	3941	100.00

Source: Ministry of Industry, Commerce and Tourism, Secretariat of Commerce Database ALICE; F.O.B. data.

The weight of both consumer and intermediate manufactured goods in total bilateral trade has remained stable, i.e., below 10 and 20 per cent respectively. Trade in consumer durables and capital goods has shown a steady rise, particularly in transport equipment where the rising intra-industry trade intensity reflects the existence of special regime in the automobile industry and investments by foreign manufacturers in a sub-regional integrated strategy. Finally, trade in primary goods has slightly increased, representing the bulk of Argentine exports to its much larger northern partner. Brazil is one of the world's largest wheat importer, having abandoned the previous goal of self-sufficiency. Until 1994, Brazil maintained a special arrangement with Argentina for import of wheat, covering two million tonnes a year. Brazil has subsequently eliminated a tariff quota under which the tariff for wheat was reduced to zero on an annual quota of 750,000 tonnes. In 1994, Brazil absorbed almost half of Argentina's cereal grain shipments- almost 80 per cent of rice exports, 70 per cent of wheat exports, and 42 per cent of rice exports, 70 per cent of wheat exports, and 45 per cent of its flour exports- as well as 55 per cent of dried fruit exports and 36 per cent of dairy products exports.

From table-4, we can get the trade balance of two countries (Argentina and Brazil), which is quiet necessary and also important at this juncture to have a clear cut understanding of the trade relationship between these two countries. So table-5 shows the trade balance sector wise.

Table 5
Trade Balance between Brazil and Argentina ($ million)

Sectors	1994	1995	1996	1997 (Jan-June)
Agriculture products and meat preparation	+1104	+1662	+1652	+896
Electro-mechanical equipment	-571	-297	-596	-255
Chemical products	-382	-434	-364	-235
Food, beverages and tobacco	-133	-5	+9	-34
Iron and steel	-423	-396	-389	-241
Mining products	+418	+667	+1060	+653
Paper and cellulose	-165	-124	-142	-68
Textiles	+19	+117	+135	+10
Transport equipment	-331	+245	+104	+127
Other goods	-10	+115	+143	+109
Total	-474	+1550	+1612	+962

Source: Own calculation based on Table –4 data.
Note: Brazil and Argentina are signified by Minus (-) and Plus (+) respectively.

TRADE RELATED ISSUES: ARGENTINE POSITION

Common External Tariff (CET) Issues

At a summit in Ouro Preto in December 1994, agreement on the structure and the CET rates were reached. Mercosur adopted an escalating tariff structure with 11 levels, ranging from 0 to 20 percent. However, the CET is applied to 85 percent of the tariff schedule. Each country has a list of exceptions to the application of the CET; for these goods the national tariffs on non-Mercosur imports continue to be in use. Their tariffs are to converge gradually and linearly to the CET, by December 2000 for Argentina, Brazil and Uruguay and by December 2005 for Paraguay. The CET is not applied to certain industries in all countries. This is the case with the auto industry and sugar production, but capital goods and goods of the telecommunication and informatics industries are excluded from the customs union. In the case of capital goods, the tariffs applied by each country must gradually converge to the CET of 14 percent by the year 2001 for Argentina and Brazil and by 2006 for Paraguay and Uruguay. The tariffs on telecommunication and informatics items will also converge to the CET (with a rate of 16 percent) by 2006 in all countries.

The average external tariff, which is applicable in non-Mercosur countries, rose steadily since 1998. The big jump in the tariff level in 2001 is related to legislation approved on March 8 and 27 when tariffs on most consumption goods were set at 35%, the maximum allowed by the WTO. The significant increase in tariff dispersion from 6.5% to 9.91% was related to the second main change introduced by the mentioned legislation, which eliminated tariffs on capital goods. Clearly these measures were aimed at improving domestic terms of trade of domestic industry in the context of a severe domestic contraction that was causing an alarming reduction in production and employment. Together with the already mentioned increase in export reimbursements, the main objective of these measures was to mimic a devaluation (i.e., an increase in relative prices of tradable goods) through trade policy instruments.

These changes were applied by using exemptions to Mercosur's CET, while the Mercosur "internal" tariff suffered no serious setback. Consequently, it is likely that the threat of welfare losses due to trade diversion increased significantly due to these unilateral measures.[11] On the other hand, the elimination of tariffs for capital good imports significantly reduced the preferential treatment of Brazilian imports of capital goods, and thus Brazilian exporters opposed this policy change by Argentina.

At the end of 2002, these measures were partially reversed. The average tariff declined from 18.2% in 2001 to 14.25% in December 2002. This reduction was due to the fall in consumption goods tariffs, which were set at the pre march

[11] There is already evidence showing that trade diversion in favour of Brazilian exporters has occurred when Argentina raised to 35% the external tariff of some CET-exempted products like textiles and shoes .

2001 level. We disaggregated import duties by main product categories and an estimation of capital-goods tariffs. The level of protection rises with the degree of elaboration of the product: primary goods and petroleum and energy products have relatively low tariffs (9.23 and 0.29%, respectively) whereas tariffs on primary-based manufactures and manufactures of industrial origin are 12.8 and 16.37% respectively. On the other hand, capital goods imports face a tariff of 3.31%, still reflecting the decrease in tariff of 2001.

We would like to briefly refer to non-tariff barriers. Within these barriers Argentina has been a significant user of antidumping (AD) measures.[12] This has taken place since the mid-nineties when Argentina updated its legislation following the Uruguay Round guidelines on these matters. The most notable pattern that emerges from this evidence is that the number of initiated AD investigations was initially high when Argentina was facing the *Tequila crisis* in 1995, they declined steadily until 1998, and increased afterwards with the coming of the economic recession in 1999 until 2001. Consistent with a view that recession and increasing import competition made instigated AD duties, during 1999-2001 we observe a big decline in the number of investigations that are closed without imposing *AD* duties. However, the picture seems to have changed in 2002 after the devaluation, when the number of initiated investigations (the least "backward looking" of the indicators) was just seven. We again can interpret this evidence as suggesting that the disequilibria observed in certain basic macro variables (unemployment, production and real exchange rate) since 1999 generated a negative spillover on trade policies.

[12] Not so much of safeguards and countervailing duties. Since 1996, Argentina has on average initiated one investigation per year in each case.

In addition to the basic tariff, Argentina has had a "statistical tax" that acts as a tariff and was modified on several occasions during this period. In October 1992, it was raised from 3 to 10 percent, but not applied to capital goods not produced domestically (after May 1993 all capital goods imports were exempted from the tax), and to products negotiated in a bilateral agreement with Uruguay. Tariff preferences under the Mercosur liberalization program did not include the statistical tax (i.e., it was still levied on them), however in May 1993 imports from Paraguay were exempted from this tax. It was eliminated in January 1995, but reinstated in March with a rate of 3 percent for all imports from non-Mercosur countries, excluding imports of fuels and capital goods. The statistical tax was successfully challenged in the WTO in 1997 and Argentina reduced it to 0.5 percent it in January 1998 as Mercosur raised its CET by three percentage points.[13] Since 1993, Argentina has also applied specific import tariffs on textiles, apparel and footwear imported from outside Mercosur.

In terms of average protection, there is a significant difference between the CET and the current tariff levels (10.7% against 14.25%). This is partly explained by the fact that the current level of the CET is 1.5% higher than the level that will prevail at the end of the current year. A second reason is that we still have national exemptions to the CET. Decision 68/2000 of the Common Market Council, have extended the permission to have national exceptions, allowing the countries to select 100 8-digit items.[14] Finally, besides the national lists, there are the exceptions for capital goods, which still, as of December of 2002, are in place. This is clearly seen by the fact that the current average tariff for these products is 3.31% while the CET is around 12.7% (including the 1.5% extra tariff).

[13] There was no net effect on non-Mercosur imports as Argentina exempted them from paying pre-shipment inspection costs.
[14] The current list for Argentina is detailed in Decree 540/2002 issued in October of 2002.

The full implementation of the CET is expected bring a reduction in Argentina's average external protection and also a reduction in the dispersion of tariff levels. This is a movement in the right direction, but it may not be enough. The fact that Mercosur countries, especially Argentina and Brazil, have now flexible exchange rate regimes makes the fear of potential overvaluations of the currency less probable. In this sense, future shocks, like declines in international prices or hikes in international interest rates, can be partially absorbed by the real exchange rate through fluctuations in the value of currency. Combined with an adequate safeguard regime in this new policy regime, tariffs should aim at assuring that resources are allocated where the social return is maximized.

Still the most conflicting issue of the CET for Argentina is the relatively high level of the CET affecting capital good imports. The full implementation of the CET implies an increase from 3.3% to 11.2%. Argentina should look for a compromise: in exchange for not delaying CET convergence, it should ask for a significant downward revision of the corresponding tariffs. This is particularly important given the existing empirical evidence that capital goods prices might play a special role in the process of international technology diffusion.[15]

Are Mercosur members willing to take these steps toward more liberalization? There is evidence that convergence in exchange rate regimes between Argentina and Brazil have brought more support to revise the structure of the CET. In fact the Council of the Common Market has decided to create a technical group to elaborate a proposal for a revised CET.

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[15] Keller, Wolfgang. 2002, "Geographic Localization of International Technology Diffusion". *American Economic Review* 92: 120-142.

Overcoming Conflicts

In Mrcosur, Brazil's relative power has led it to adopt a *modus operandi* of taking actions first and asking questions later – setting limits on imports or exports or erecting nontariff barriers without consulting other Mercosur countries, and negotiating only when those countries protest. The pattern is illustrated by the cases that follow: one, from the automobile industry and another from the import-financing sector. This behavior, in turn, is possible because Mercosur has no formal dispute settlement system; all disagreements and conflicts must be handled by political negotiation.[16] The following cases demonstrate, however, that despite the "imminent demise" of Mercosur that is predicted each time such conflicts occur, the regional bloc clearly has enough staying power to overcome the problems.

The Automobile Conflict

Brazil took this assertive stand in the automobile sector on June 13, 1995, when, facing a mounting trade deficit associated with its crisis-ridden economic stabilization plan, it announced that it would limit imports of automobiles in the second half of the year to 50 percent of the total of imports in the first half of the year. To the shock and surprise of Argentina, the decree that announced this decision made no exception for Argentine auto exports to Brazil. Some Argentine observers feared that MERCOSUR itself was in danger because of this unilateral decision. Argentine president Carlos Menem threatened to boycott a summit meeting of the Mercosur presidents scheduled later that week in Sao Paulo, declaring, "I don't understand Brazil's position .... If we are going to erase

[16] O'Neal Taylor, Cherie, 1997. Dispute Resolution as a Catalyst for Economic Integration and An Agent for Deepening Integration NAFTA and MERCOSUR? *Northwestern Journal of International Law and Business*, vol. 17, No. 2-3, pp. 850-99.

agreements we have just signed, I don't think it suitable for me to go to that meeting" (Reuters 1951b).

What was unexpected was the failure to exempt Argentina from the policy, at least initially. Eventually, Brazil rescinded this decision. President Menem agreed to attend the summit meeting when Brazilian president Fermando Henrique Cardoso pledged a negotiated settlement of the dispute and suspended application of the quotas to Mercosur partners for 30 days. Negotiations proceeded apace and resulted in a two-part agreement: Brazil would not apply the quotas to Argentina for the remainder of 1995, and the two countries would begin negotiations to establish a definitive common automobile regime that would last until the year 2000 (at that point, the common external tariff would take effect in the auto sector, and trade between the two counties in the sector would be completely free).[17]

What was really at issue were the imminent new trade regulations for automobiles under Mercosur, which Brazil feared would influence Transnational Companies (TNCs) investments in the region. Analysts in both Argentina and Brazil believed that the agreement reached at Ouro Preto, Brazil, in December 1994, which set the final policies of the customs union, favored Argentina. Under this accord, Brazil allowed Argentina to continue to demand that car makers export as much as they imported -a policy that acted as a nontariff barrier in the auto industry. While Argentina received this beneficial arrangement, Brazil opened its market to Argentine car imports unilaterally.

This became a concern for the Brazilians once the pace of investments picked up as Mercosur became a reality. The concern was clear both for the Brazilian state which hoped to increase overall investment in the economy and for

[17] Cason Jeffrey, "On the Road to Southern Cone Economic Integration", *Journal of Interamerican Studies And World Affairs*, vol.20, No. 1, 1999, pp. 23-41.

the automakers, free access to the Brazilian market of 160 million. The Brazilian policymakers were concerned that more investments would go to Argentina. The Brazilian officials began to fear that they were allowing their auto industry to shrink, while firms already established in Brazil were concerned that rival firms would gain a competitive edge by taking advantage of Argentina's attractive terms.

The true nature of the dispute was made clear when Brazil announced its new quota policy. Argentine industry secretary Carlos Magarinos noted two days later, "the real dispute is overinvestments" (Reuters 1995a). This was obvious for several reasons, most notably that the Brazilians reduced tariffs on non- Mercosur autoparts imports to 2 percent from a previous rate of 18 percent (Reuters 1995c).

On 22 January, 1996, Brazil and Argentina announced agreement on the auto regime that would be in place until 2000. Many observers concluded that the interim agreement leveled the playing field between the two counties, as it established some basic rules to encourage auto 'TNCs to invest in Mercosur. In Brazil, auto exports could import as much as they exported, paying half of the 70 percent duty normally levied on vehicles. In Argentina, the previous policy of requiring firms to export as much as they imported was maintained. In addition, to strengthen the local parts industry and avoid investments based only on assembly, duty-free intra - Mercosur trade in automobiles required that at least 50 percent of the components be made in the exporting country. Brazil continued to levy only a 2 percent duty on extraregional autoparts imports, while Argentina counted the purchase of capital goods for the auto industry as an investment for purposes of tax breaks.

Precisely the point is both the Argentines and the Brazilians believe that the auto industry can contribute to economic dynamism in the region. The point was reinforced by more recent negotiations over the auto regime, which concluded in late 1998. The new agreement established a four-year transition period, from the beginning of 2000 to the beginning of 2004, for a complete free market in the Mercosur auto sector. The agreement has a provision of much higher tariff than the average Mercosur tariff: 35 percent for finished vehicles. The agreement also established a common 14-to-18 percent tariff on autoparts and increased the minimum Mercosur content of vehicles (if they are to be considered Mercosur vehicles) to 60 percent (inter Press Service 1998). All in all, this arrangement is quite protectionist and, in this sense, reflects Brazilian goals in the region.

Those fears, however, appear to have been unfounded. Over the course of 1995, the height of the crisis in the bilateral relationship, transnational auto firms committed an investment level of $9.4 billion in Brazil and $4.7 billion in Argentina. This difference is certainly reasonable, given that Brazil's auto market is much larger than Argentina's. In 1997, for example, total sales of the transnational auto firms reached $25.9 billion in Brazil and $9.7 billion in Argentina (ECLAC 1998). This proportion is roughly comparable to the two countries' relative economic weight. In 1997, Argentina's GNP amounted to $306 billion, while Brazil's totaled $773 billion (World Bank 1998, 190).

The Import-financing Conflict

The resolution of the auto conflict set a pattern that is likely to persist in intra-Mercosur relations in the foreseeable future. Another example helps make this case. On March 25, 1997, Brazil issued *Medida Provisoria 1569*, requiring importers in Brazil to pay cash for most imports. This was meant to counteract the common practice of using low interest rate credits (in dollars) to purchase imports, which would then be sold in the Brazilian market. Because the loans did not have to be repaid immediately, importers would then invest the proceeds at higher interest rates in Brazil, thereby gaining a profit on the differential between domestic Brazilian interest rates and the international rates at which the importers had borrowed the money. The only exceptions to paying cash for imports were on shipments of less than US$10,000, oil and petroleum by product imports, and financing that exceeded 360 days. In all, the requirement to pay cash for imports was meant to affect 65 percent of all Brazilian imports, including those from Mercosur.

The decision, taken largely because of an increasingly threatening balance-of-payments deficit, initiated another salvo of protest from Brazil's Mercosur partners. The Mercosur nations complained that this was yet another example of Brazilian arrogance and hegemony. As a spokesman for Uruguay's exporters' association put it, this was just another way Brazil was "marking the rhythm to which the rest of us dance" (*Inter Press Service* 1997d).

As with the auto conflict, however, the Brazilians were willing to negotiate with their Mercosur partners toward at least a temporary solution. The result was an exemption for Mercosur partners in which shipments of less than US$40,000 would not need to be paid for in cash; instead, these relatively small shipments could be paid for in credits of up to 89 days. This exception lasted until July 31, 1997.[18]

Given the Brazilians' rather paltry concessions, Argentine business enterprises were still not happy with the resolution. In the process of negotiating

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[18] Ibid.

after they had adopted a unilateral measure, the Brazilians still got most of what they wanted.[19] Although Brazil has thrown its weight around Mercosur, nothing has derailed the economic bloc. Indeed, in the case of the import financing conflict, the bloc's growing importance restrained Argentina from precipitating a debilitating crisis, given Argentina's growing dependence on the Brazilian market. After the early tumultuous phase, with its full round of recriminations moreover, the Argentines began to downplay the crisis itself recognizing that Brazil was really forced to do something about its balance of payments position. If Brazil's problems were to lead to Mexico like financial crisis, Argentina would suffer enormously.

In the ultimate analysis Argentine exports apparently were not greatly affected by these import financing restrictions. Total Brazilian imports actually increase after the new import financing restrictions were enacted i.e., from US$4.84 billion in March 1997 to US$6.05 billion in July 1997.

The examples of the automobile and import-financing sectors both demonstrate that Mercosur has managed to overcome even relatively serious clashes. Brazil's political and economic weight in the process gives it the power to drive the agenda. Negotiators also appear to recognize that conflict is normal in such a process.

Investment Flows

Over the last few years, Latin America- and the Southern Cone in particular- has been attracting large FDI flows (Tables 5 and 6), partly pulled by large-scale privatization policies. Integration should boost FDI flows, in so far as the positive effect stemming from the increased size of the potential market

[19] Teubal, Miguel. Mercosur, Argentina and Regional Integration Processes. *International Journal of Political Economy*, vol. 26, No.4, 1996, pp. 56-70.

outweighs the fact that liberalization makes it more convenient to trade from the home country rather than establishing a direct presence in the region. Moreover, to the extent that such arrangements are deeper than first-generation customs unions, to include, for example, the elimination of barriers to capital flows and trade-related investment measures, they may signal a commitment to free trade and therefore lower the risk faced by foreign investors pondering the opportunity of a large sunk-cost investment (Blomstrom and Kokko, 1997).

Table 6
FDI Flows to Mercosur Countries (US$ million)

	1984-89 average	1990	1991	1992	1993	1994	1995
Argentina	653	1,836	2,439	4,179	6,305	1,200	3,900
Brazil	1,416	989	1,103	2,061	1,292	3,072	4,859
Paraguay	6	76	84	137	111	180	200
Uruguay	29	42	32	1	102	170	200
Mercosur total	2,104	2,943	3,658	6,378	7,810	4,682	9,159
As percentage of Latin America's total	27.19	33.07	23.81	36.04	40.14	18.50	34.48
As percentage of developing countries' total	9.48	8.72	8.86	12.66	10.68	5.38	9.19

Note: data include FDI flows among Mercosur countries
Source: UNCTAD (1996), World Investment Report, Annex table 1.

Table 7
Sector-wise Share of FDI Stock in Brazil and Argentina (1992-95) (% share)

	Brazil	Argentina
Food, beverages and tobacco	14.0	45.1
Textiles, clothing and leather	-2.8	0.6
Wood, paper and rubber	-0.7	-3.1
Chemicals and pharmaceuticals	50.1	33.2
Non-metallic minerals	--	1.8
Metallurgy	2.9	2.4
Machinery and equipment	15.8	5.4
Transport equipment	48.7	14.5
Others	-28.0	--

Source: IMF database (1997), Table 4 and 61.

While the precise role of Mercosur per se as a factor originating, rather than simply reinforcing, investment decisions can only be gauged through surveys, there can be no doubt that in some sectors, and possibly more in Argentina than in Brazil, a profound reallocation of production is underway as competitive advantages assert themselves at Morcosur level.

INVESTMENT RELATED ISSUES

The analysis of Transnational Corporations' (TNC) strategies in Mercosur during the 1990s is mainly based on the framework derived from the so-called 'eclectic paradigm' of Foreign Direct Investment (FDI).[20] According to this paradigm, FDI is classified into four types, according to its main motivation: resource seeking, market seeking, efficiency seeking and strategic asset seeking.

Marker-seeking investments are aimed at exploiting the host country's market (and, eventually, neighbour countries' markets). The size and growth prospects of the market, the existence of physical barriers and/or, high transport costs, and the host country" economic policies-including especially, but not only, the degree of protection for domestic production-are key influences for this type of FDI, which became the predominant motivation for TNCs during the ISI process.

Market-seeking strategies prevailed in Argentina, Brazil and Paraguay in the 1990s.[21] In contrast, in Uruguay resource-seeking strategies were predominant in terms of investments amounts, although market-seeking strategies have

[20] Dunning, J. 1994. Re-evaluating the benefits of foreign direct investment, *Transnational Corporations*, vol. 3, no. 1

[21] This finding is consistent with the fact that different surveys made to foreign affiliates operating in the region show that the size and dynamism of domestic markets have been the key factors of attraction for FDI in both Argentina and Brazil.

prevailed if one considers the number of foreign firms involved in each kind of strategy and their market shares.

In certain cases-mostly in the services sector market-seeking strategies have been 'pure', in the sense that foreign affiliates do not export (or if they do, exports are not made on a regular basis). This type of strategy is, in relative terms, dominant both in Argentina and Uruguay, while it was less relevant in Brazil.[22] This is a reflection of the fact that most recent FDI inflow in Mercosur have gone to the services sector. With the exception of Paraguay, TNCs operating in these sectors exhibit lower import coefficients than the average for the whole of foreign affiliates; in fact, in the case of Brazil, the affiliates in these sectors make almost no imports. The differences between countries may be accounted for by the different sectoral composition of the investments included in this category. In the case of Paraguay, a great part of pure market-seeking investments corresponds to commercial affiliates which distribute imported goods from Mercosur,but mainly from non-Mercosur countries; hence, they exhibit a very high import coefficient. In Argentina, besides privatised public utilities- which make significant capital goods and inputs imports- there are many TNC affiliates that distribute imported electronics products, computers, telecommunications equipment, etc. that are not made in the country. In contrast, Brazil has managed to build up an electronics industry; hence, those TNC affiliates do not appear in this category, which is mainly composed of firms operating in the retail and wholesale trade as well as in sectors such as construction, transport, etc.

Market-seeking strategies also prevail in the manufacturing industry, although foreign affiliates in industrial sectors, even if primarily oriented towards

[22] However, it must be taken into account that this analysis is based on 1997 data for Brazil, while privatisations undertaken between 1998 and 2000 might have considerably increased the incidence of this strategy.

domestic markets, also undertake export activities. Here market-seeking strategies within the manufacturing sector is divided in two groups: I) low export-orientation: we include in this category that moderate export-orientation: we include in this category those sectors whose export/sales ratios are higher than the average of the host economy. It is important to highlight the fact that even within the latter group, it is hard to find firms with export coefficient above 25%. In other words, TNC affiliates within the manufacturing sector have not engaged in 'export-oriented' investments in these countries.

It is important to highlight the fact that the sectoral composition of each group is not the same in all countries. Sectors such as information technology equipment and telecommunications and non-metallic minerals have a low export orientation both in Argentina and Brazil. Likewise, the rubber, plastics and automotive sectors show a moderate export orientation in both countries. In contrast, the production of food, beverages and tobacco has a low export orientation in Argentina, but a moderate one in Brazil. The converse occurs for clothes, machinery and electrical equipment (low export orientation in Brazil and moderate in Argentina). This suggests that sectoral dynamics has a direct influence on TNC strategies in some cases, but that national environments also pay an important role in that connection.

Foreign affiliates operating with market-seeking strategies with low export orientation exhibit and export coefficient much lower an average than their import propensity. Hence, it is not surprising that this group of affiliates, as a whole, operates with strong trade deficits in the four countries under study. Sectors linked to high-tech activities (electronics, information technology and telecommunications equipment) tend to show the highest import coefficients and/or the larger difference between import and export propensities, at least in Argentina and Brazil.

Mercosur is a significant destination for this group's exports; extra-regional exports represent only 2.3% of the sales of market-seeking TNCs with low export orientation in Argentina, 2.6% in Brazil and 1.8% in Paraguay.

The 'market-seeking with moderate export orientation' strategy accounted for more than 50% of TNC sales in Brazil; in contrast, their sales were hardly over 25% of total TNC sales in Argentina and around 15% in Urugay.Since Brazilian industry is the most competitive among Mercosur countries, it is no surprise to find that TNCs in that country are more export oriented than those of Argentina and Uruguay.

Regarding resource-seeking strategies, their weight is low in Brazil, while they are relatively more important in Argentina, Paraguay and particularly in Uruguay (in these three countries, agricultural resources account for the bulk of these investments but, in Argentina, oil and mining investments have also been very important in the 1990s). Resource-seeking TNCs operate in the four countries with high export propensities (more than 70% in Argentina and Uruguay[23] and almost 50% in Brazil) and low import coefficients. Exports are mainly directed to extra-zone markets. In turn, imports from Mercosur countries are not significant.

As already mentioned, TNCs investments in the 1990s have included both efficiency as well as strategic asset-seeking components. However, in both cases these components have almost always been a complement of the primary

[23] Excluding the tourism sector, which can be considered, at least in Uruguay, as part of the resource-seeking strategy.

motivation, i.e., market seeking. Efficiency-seeking strategies of TNC affiliates in Mercosur is analysed below.

In turn, asset-seeking objectives have been present mainly in Argentina and Brazil. In general, TNCs have looked for the domestic market share of the acquired firm, rather than its equipment, human resources or technological capabilities. This means that TNCs in Mercosur countries seek assets that are strategic in relation to the firm's performance at the national or regional level (i.e., brands, distribution channels, consumers loyalty, etc.), but they are rarely seen as strategic for the corporation's global performance. The exception to this rule in Brazil, where TNCs have acquired domestic firms that had already gone through significant learning processes which not only resulted in the possession of valuable technological assets and high efficiency and quality levels, but had also allowed some Brazilian firms to install production facilities in the US and Europe to attend those markets-the cases of the automobile part makers Metal Leve and Cofap, both acquired by TNCs in the 1990s, are the most important in this regard.[24]

In fact, in the 1990s, many TNCs operating in tradable sectors adopted strategies in which each Mercosur affiliate tends to specialise in certain products or production lines, exporting the resulting products to the other Mercosur countries and importing inputs and final products from those countries or from other locations. Exports and imports of this kid are usually of an intra-firm nature.

Efficiency-seeking strategies are more widespread in sectors such as electrical domestic appliances, petrochemicals, food and beverages,

[24] The perception that Brazil may offer valuable strategic asserts for TNCs is in line with the findings of a survey whose results are reported in Dunning (1996), who points out that Brazil has been considered by several TNCs as a source of 'created' assets (both technological and managerial), which might contribute to maintaining or improving the corporation's competitive position at the international level.

pharmaceutical, cleansing and personal care products, tyres and, most notably, in the automotive industry. Those strategies are generally deployed within Mercosur, and especially between Argentine and Brazilian affiliates, which have tended to specialise in certain complementary product lines. Specialisation has thus led to increasing trade flows between affiliates in both countries. In contrast, Mercosur affiliates have seldom integrated within efficiency-seeking networks with other affiliates in developed countries.

The spread of efficiency-seeking strategies goes hand in hand with the gradual abandonment of the 'stand-alone' model that was typical of the ISI stage and the adoption of simple and, less frequently, complex integration schemes. The available evidence suggests that, unlike what happens with affiliates in developed countries, the reinforcement of integration schemes within the TNCs networks have hardly ever involved the transfer or corporate strategic functions to affiliates in Mercosur countries. For instance, Mercosur affiliates rarely undertake R&D or product and process design activities (in general, they only carry out adaptive tasks, and these are mainly concentrated in Brazilian affiliates), since these functions are centrralised in their parent company or in affiliates located in developed countries. The same goes for activities such as market development and marketing.

Nonetheless, even at the Mercosur level, the adoption of efficiency-seeking strategies and of intra-corporation integration schemes still seems to be in its infant stage, and is still very dependent on macroeconomic fluctuations in Argentina and Brazil. In fact, it is only in the automotive industry-which, as already mentioned, was favoured by specific sectoral policies that have been in force both in Argentina and Brazil- that the adoption of efficiency-seeking strategies has led to the establishment of 'strong' integration schemes. The international strategies of automotive industries are increasingly based on the settlement of sub-regional production and distribution centres, where vehicles, parts and pieces are mutually exchangeable among the different affiliates. Mercosur has become one of these centres. As a consequence, investment projects are envisaged for the regional market as a whole, and production plans articulate the activities of the different affiliates of the corporation through complementary specialisation schemes. Firms seek to reduce the number of platforms used in each plant and assign only one or two models to each plant, usually as a 'product mandate' for the Mercosur region, to reach efficient scale ranges. They complement domestic supplies through intra-firm trade. Imports and exports flow among Mercosur TNC affiliates in this industry has thus grown considerably.

MERCOSUR'S RELATIONSHIP WITH EU, SAFTA AND FTAA: ARGENTINE POSITION

The Relationship between Mercosur and the EU

Trade and Investment

In the first half of the 1990s Mercosur attracted over 50% of European foreign direct investment (FDI) to Latin America, against 40% of total US and Japanese FDI.[25] Privatisation and increasing trade apart, the Mercosur counties were looking for foreign funding for the modernisation and interconnection of their energy sources, ports and telecommunications. As it could attract FDI, Mercosur was seen as an 'ignition key' for development.

[25] From 1990 the UK was the largest European investor in Mercosur, making up a third of the total, Germany and The Netherlands followed, with about the fifth each, and France and Spain came next, with another fifth between them.

The EU's trade interest increased with Mercosur's economic growth after the Cavallo and Real stabilisation plans, through which inflation fell drastically and credit returned to the economies. Growth averaged 3.5% per year from 1990 top 1995, in spite of the Argentinean economic slow-down following the 'tequila effect' of the Mexican financial crisis in December 1994. Mercosur's intra-regional trade grew by 306% between 1990 and 1996, in great part thanks to the bilateral trade between Argentina and Brazil, and can still expand expand if the regional rate of economic growth is maintained. Intra-regional exports showed an impressive increase from less than 10% to 25.8% of total trade in 1998,[26] and are similar to ASEAN'S (24.5% in 1997[27]). Yet they are rather low when compared with the EU (60%) and NAFTA (50% as a whole, and 70% for Canada and Mexico).

As regards Mercosur's extra-regional exports, in1994 (when the option for a customs union was favoured), Europe was the main destination, receiving some 27% of exports, compared with 17% for the USA. Between 1990 and 1996 the highest growth rates were among exports to LDCs. The percentage of average annual growth rate of Mercosur's exports to Latin America was 16.4% and to Mercosur partners 22%. Exports to DCs showed a much lower growth rate. Among DCs the USA appeared as the least dynamic export market with 1.9%. Meanwhile, imports reflected liberalisation policies, showing an inverted situation where imports' average annual growth rates were evenly distributed among various regions of the world. Between 1990 and 1996 Mercosur imports from the

[26] IADB, Integration and Trade in the Americas: A preliminary estimate of 1998 trade, Inter-American Development Bank, Periodic Note, December 1998.
[27] Internet source: www.asean.or.id/stat/extra6.htm.

EU grew by 20.4%, against 19.8% from the USA, 17.5% from Latin America and 19.2% from Mercosur members.[28]

The diversification of trade flows supports the notion that Mercosur is a global trader, thanks to Argentina and Brazil. This diversified articulation explains Mercosur's interest in both 'open regionalism' and a multilateral system under the surveillance of the World Trade Organization (WTO). A strong WTO may enable Mercosur countries to defend their interests without being excessively dependent on just one developed country or region. In Tussie's words: 'Because globalisaion entails a logic of multipolarity, the leading edge of liberalisation lies in regionalism'.[29]

In 1992, when the first steps to institutionalise the inter-regional relation was taken, Mercosur represented 53% of all Latin American exports to the EU. Meanwhile, the EU was its first trading partner and its first source of FDI (with 36% in capital stock) as well as for financing development cooperation and technical assistance. Although the EU remained Mercosur's first partner in 1994, a declining tendency could be observed. By the year 2000 trade will have decreased to 22% of the total, while trade with the USA will finally overtake that with the EU. Nonetheless, according to the EC, an inter-regional agreement to liberalise trade could neutralise such a tendency, bringing trade back to 36%.[30] Competition for market access thus appears to be conveyed and pursued on a regional basis.

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[28] Sanchez Bajo Claudia, "The European Union and Mercosur: A Case of Inter-Regionalism", *Third World Quarterly*, vol. 20, No.5, pp 927-941, 1999.

[29] D Tussie, 'Emerging Regionalism in America', in Coleman & Underhill, *Regionalism and Global Economic Integration*, P.95.

[30] Argentine Mission to the EU, Economic Department, Support documents to discuss the approaval of the mandate to negotiate the Framework Agreement of Trade and Economic Co-operation. 20 April 1995.

The 'Framework for Cooperation' between the EU and Mercosur

The 'EU-Mercosur Inter-regional Framework for Cooperation Agreement' was signed in Madrid on 15 December 1995, exactly the same day that the Ouro Preto Protocol came into force, locking in Mercosur's option for a customs union. The Framework was the next step from the 1992 Inter-Institutional Co-operation Agreement, the Joint Declaration of 22 December 1994, and the Declaration on Political Dialogue of 15 September 1995. The 1994 Declaration the established two 'pillars' of the relationship: the institutionalisation of a political dialogue, and economic negotiations towards the creation of a free trade area.

The Framework leads to the preparation of a draft for an inter-regional association agreement and it deals with trade (agricultural, food, industrial and customs as well as intellectual property and service), economics (investment, energy, transport, science and technology, and environmental protection), and a system for exchange of information.

The Framework ensures cooperation on technical norms (agro-industrial and industrial one in particular) and on customs (articles 6 and 7). Business cooperation (article 11) focuses on the main concept-networks-and one main target-small and medium enterprises (SMEs).[31] Investment issues (article 12) also focus on SMES and on achieving a stable and secure legal environment. All these points reflect the major rationale of the Framework: beyond trade liberalisaiton, world economic restructuring and insertion go hand in hand, after which intra-firm and intra-industry trade coordination is eased through both harmonisation and legal security. Thus, in reality, the Framework Agreement has been the preparatory stage for trade liberalisation.

[31] E D Mansfield & H V Milner (eds.), *The Political Economy of Regionalism*, New York: Columbia University Press, 1997.

Here it is a need to discuss about the political pillar of the inter-regional relationship between Mercosur and EU. From the very start, Mercosur's efforts to expand its linkages have intensified the debate concerning its degree of institutionalisation. The EU has played an influential role in furthering the latter. Given the EU's longer existence and more solid institutionalisation, many important actors in Mercosur tend to view it as a desirable model. The main perceived advantages have been the maintenance of an overall social and political cohesiveness, through the recognition of regional, reliability stemming from common regional policies and supranational institutions.[32] Following this path would broaden Mercosur's authority. The other model at hand has been NAFTA. The USA has accepted regionalism for the first time, and with it access to the US market appears a tangible prospect. This vision of regionalism is restricted to free trade and endorses low institutionalisation, looking forward to an American free trade area.

The advantages of EU-Mercosur liberalisation were mutual: 'Mercosur can slowly adapt its economies to European competition, diversify its exports, and adjust to EU norms and standards. The EU can create conditions for improving the access of "sensitive" Mercosur agricultural products-beef, wine, vegetables and fruit-to the European market by reducing the subsidies of its common Agricultural Policy'.[33] Certainly, trade and investment have been the issues attracting most attention.

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[32] R Z Lawrence, *Regionalism, Multilateralism, and Deeper Integration,* Washington DC: Brookings Institution 1996, p. 60.
[33] IRELA, Mercosur, p. 38, endnote 8.

EU-ARGENTINA RELATIONS

1. Argentine Position

Argentina has had a long tradition of European immigration, which has led to strong economic, social and cultural transatlantic links, especially with Spain and Italy. Furthermore, the EU is its first partner in cooperation, its first investor and its second trade partner after Mercosur (regional block including Brazil, Paraguay and Uruguay together with Argentina). Argentina was the first country of Latin America, which formalised its relations with the EU under the form of a third-generation cooperation agreement. The "Framework Trade and Economic Co-operation Agreement" between the EU and Argentina entered into force as soon as 1990. It included as fundamental principles two recurrent cornerstones of our cooperation policy: the strengthening of democracy and human rights, as well as regional integration. The follow-up of the agreement entails periodic meetings of the "EU-Argentina Joint Commission". During the nineties, several sectoral agreements were concluded in this framework on sea fisheries, the peaceful use of nuclear energy, and science and technology.

A process of inter-regional association between Mercosur and the EU has been in the phase of negotiations since end-1999. This process appears high in the agenda of President Kirchner. The Last EU-Mecosur Ministerial Meeting took place in November 2003 and established an ambitious work programme that could lead to the signing of the Association Agreement in 2004. The last EU-ALC Summits of Rio and Madrid were opportunities for the Transatlantic Partners to express their support for their common political values, common economic issues (trade and investment, in particular the EU-Mercosur Association Agreement; the Doha work programme; global governance) and other shared topics such as cultural diversity, migration, and to launch horizontal cooperation programmes.

The first CSP (Country Strategy Paper) which set the EU strategy with Argentina for the period 2000-206, was drafted just before the December 201 crisis. The EU could not, and did not, ignore such as dramatic crisis. Now, a revised CSP is in the phase of being adopted by the Commission.[34] It reflects the new situation of Argentina and the response strategy of the EU.

2. Economic and Trade Relations

After four successive years of recession, with negative growth of 10.9% in GDP, in 2002, Argentina showed a strong rebound in 2003. This is mainly due to an export-driven increase of production in the agriculture sector (in particular soya), two-digit growth of industry (16% up in 2003) and the tourism and construction sectors. The favorable exchange rate, resulting from the devaluation of the Argentine peso, has permitted this high export growth (23% in 2003, compared to 2002). Argentina is therefore trying to improve and extend its international market access, looking for the conclusion of new trade agreements.

Major opportunities could come from the deeper integration of Mercosur and the ambitious project to build its common market before 206. In particular, this would create new trade opportunities with the EU. Indeed, the EU is already Argentina's second trade partner after Mercosur, representing 19% of its exports in 2002. The EU is also the first investor in Argentina (EU's Foreign Direct Investment stocks: Euro 52.3 billion). Naturally, most investors were also affected by the crisis. Some pending issues concern the situation of companies (mostly European) running the privatised public services, the reform of the banking sector (several European banks are concerned) and the public debt with private

[34] http://europa.eu.int/comm/external_relations/argentina/intro/index.htm.

bondholders (of which there are many Europeans: Italians and Germans essentially).

3. Response Strategy and Cooperation

Before the crisis, a bilateral cooperation programme between the EC and Argentina had been launched in the framework of the EU-Argentina Agreement signed in 1990. It focused on economic cooperation in the mutual interest (2/3 of the available funds), the rest being earmarked for social and institutional projects. With the crisis, this programme lost most of its significance. However, the EU used other means to bring assistance: its comprehensive response strategy has included short-term, mid-term and long-term elements. Some of the instruments aimed for an immediate impact: in 2003 ECHO, the Humanitarian Office of the EC, launched two emergency projects in provinces particularly damaged by the sudden rise of poverty and by a natural disaster; a part of the bilateral cooperation funds were re-directed to a programme aiming to support community food projects.

Other instruments needed some time to yield results. Two clauses were added to the regulation of GSP (Generalised System of Preferences) in order to exempt economies in crisis, as well as beneficiary countries with trade flows below 1% of the total EU GSP flows, from graduation; the EU put in place exceptional temporary measures to ease the import of Argentinean meat and wine; in a general way, the increase of Argentinean exports to the EU from 2001 to 2002 compensated the loss of Argentinean exports to the rest of the world in the same period. Furthermore, the EC worked to raise awareness and collaboration among the EU Member States, in order to prepare the decisions regarding Argentina in the boards of the World Bank and the International Monetary Fund.

Other instruments have long term objectives to promote sustainable growth: the joint participation of Argentinean and European organisations in the EU Science and Technology programmes, as well as in the horizontal cooperation programmes such as AL-Invest, @LIS (Information Society), αLFA and ALβAN (cooperation between Universities) is high and growing.[35] The bilateral cooperation programme is being restructured in the framework of the CSP revision, in particular to take the new social crisis into account and to prepare Argentine operators to deal with new commitments resulting from their new regional, bi-regional and international agreements.

MERCOSUR'S RELATIONSHIP WITH SOUTH AMERICAN FREE TRADE AGREEMENT (SAFTA)

Following the 1995 agreement between Mercosur and the EU, the intention is to arrive at a free trade agreement between the two blocs, which would be something totally new, a free trade agreement between two blocs and over two continents. Former EU commissioner Manuel Marin, responsible for Latin America, wanted to get this agreement signed by 1999 or 2000 at the latest. However, two additional problems slowed down the negotiations. First, member states wanted to wait for the round of new negotiations for the WTO-which had not got off the ground since the Seattle debacle in November 1999-to a avoid having to make concessions twice. Second, internal reforms and enlargement seem more pressing problems than furthering trade with Mercosur. Even so, talks are moving ahead slowly, and in July 2001, The then EU commissioner of trade, Pascal Lamy, during a visit to Brazil, presented the Mercosur member states with a ten-year liberalization proposal over 100 percent for industrial products and 90

[35] Ibid.

percent of agriculture. In fact, the EU is the first trading partner of Mercosur and may be it does not want to lose its advantage to the United States, which is pressing so aggressively for the FTAA.

To counter that threat in some way, the Brazilian government would like to go beyond Mercosur and, if possible, create the (SAFTA) but also strengthen its ties across the Atlantic, especially with South Africa, and with Asia. This last continent is becoming an even more important trading area for Brazil, and more than a trading area, as agreements are being made to bolster technological co-operation, joint research projects, and in other areas of mutual interest, even if there are some bumps along the road.[36] The creation of SAFTA would be a way to strengthen relations within South America, and be in a better negotiating position for the establishment of a FTAA.

Meanwhile, for Mercosur, the association with Chile and Bilivia in 1996 is already an auspicious start for SAFTA. In 1997, the Peruvian government asked to become associated. According to Article 20, of the Asuncion Treaty, all countries, members of the Latin American Integration Association (ALADI) may enter into negotiations to join to Mercosur. These countries include all South American countries and Mexico. A couple of months later, during the Ibero-American summit which was held in Venezuela in November 1997, the members of the Andean Community (also known as Andean Pact or Group), Colombia, Ecuador, Peru, and Venezuela decided they wanted to speed up the integration process with Mercosur. The idea is to create a strong bloc, to have more influence on the ongoing negotiations, before entering FTAA. In a meeting of South American

[36] IRELA, Dossier 61, "Mercosur: Prospects for an Emerging Bloc," pp. 30-33.

heads of states in Brasilia in August 2000, in the final *communique*, President Cardoso announced that the aim was to establish SAFTA by the end of 2002.

The whole region received a boost with the summit meeting of all South American heads of states in Brasilia in August 2000. Besides the discussions around, SAFTA, which, if it could be got off the ground, would theoretically boost cooperation throughout the whole continent, the development of a better infrastructure and the achieving of complementarity, which would certainly be helpful. The other issue addressed was the situation in Colombia, and foremost the U.S. billion-dollar "aid" package in the form of weapons with many consequences for other South American countries. Brazil, for one, does not want to involve itself in internal problems of other governments. In July 2001, in spite of all the problems, and most recently, a high-level meeting was held to stimulate negotiations between Mercosur and the Andean Community.

Altogether Mercosur is performing quite will, and in spite of some major crises, of which the present one seems the most important, it is moving forward.[37] An important factor may well be that all-powerful organizations, such as the Sao Paulo Federation of Industries (FIESP), serve to underline the importance of Mercosur, but also organization such as the Mercocidades (Net of Mercotowns), an initiative developed at the local level in 1995 to stimulate cooperation between municipalities at political, economic, social, and cultural levels, want to strengthen Mercosur.[38] There are many more associations, from very different sectors of civil society, which have the same purpose. Inevitably these associations prefer to

[37] C. Baneg, e.a., "The New Regionalism in South America," in M. Schulz, e.a., ed., *Regionalization in a Globalized World...*, pp. 234-49.

[38] Wiesebron L. Marianne, "Transformation in Latin America-Integration, Cooperation, and Reforms", in *The Japanese Economy*, vol. 29, no. 4, July- August 2001, pp. 5-32.

increase cooperation with the EU, rather than with the United States, especially in the social field.

THE FTAA AND THE FUTURE OF MERCOSUR

Around the second half of 2000 and in the midst of the Mercosur crisis, the American economy started to show signs of a slowdown. At the same time, Brazil was furthering its South American initiative. Because of their loss in the U.S. presidential elections, the Democrats tried to create new facts that would lock Bush's presidency into an acceleration of the FTAA negotiations.

Among the American actions that were taken to implement this strategy were the cooperation of Chile, renewing the old promise to integrate this country into NAFTA. Chile, a weak country, which does not present a strong economic presence, and which seems to be incapable of articulating a national project, pins all its hopes on this arrangement. Argentina, in its turn, plunged in a deep economic and financial crisis, is also tempted to make huge concessions in the FTAA negotiations, in exchange for bilateral favors in its economic relations with the United States. Therefore, the external context has been disadvantageous to Brazil.

One possible apprehension is that the creation of the FTAA would mean the end of Mercosur, once it reached the point of nullifying the advantages that the Common External Tariff (CET) offered the firms of member countries.[39] Moreover, for Brazilian states economies such as that of the Rio Grande do Sul, American cattle and agricultural exports would represent a real threat (especially soybean, rice, manufactured agricultural products, cattle, and poultry farming).

[39] Vezentini Paulo G.F., "Mercosur at Crossroads", *The Japanese Economy*, vol. 29, no. 4, July-August 2001, pp. 33-53.

The outcome of this dispute will depend very much on Brazilian diplomacy. Several analysts argues that, if Brazil did not take part in the FTAAs negotiation, it would be isolated. This is not true, since Latin American countries do not compete with Brazil on either the Latin American or on the North American market. Most of these countries have already gained commercial privileges in the United States. As Ambassador Samuel Pinheiro Guimaraes recalls

> Considering South American countries, their limited industrial diversity and the size of their economies also restrain their ability to compete with Brazil in the American (and hemispheric) market. Moreover, their exports to the United States are different from Brazil's, focusing on primary products that we do not export, such as the Chilean copper, oil from Venezuela and Ecuador, Peruvian and Bolivian ores, etc. Argentina's case is more interesting, since it produces and exports the same products that the Untied States also exports in great quantities, grains and meat, and its priority market is the EU. It is hard to see what Argentina might gain in the trade or in the field of investments with its participation in NAFTA or even in a future FTAA.[40]

Therefore it should be noted that, despite all its limitations, Mercosur represents not only a trade initiative, but also a strategic one, which clashes with North American interests. Inside the FTAA (that is not a mere trading project), we would lose our legal capacity to make use of the mechanisms of industrial, technological and commercial policies to accelerate development. In Mercosur this would be possible as long as the national governments could free themselves of their present ideological chains. Brazil, in its turn, needs to avoid the traps created by the despair of Argentina (which depends on the Brazilian market) and begin to mobilize its social and business sectors against the risks presented by the

[40] Interview on www.global21.com.br, 29 December 2000.

FTAA, rousing them from their lethargic condition and confronting the crux of this critical issue: regional integration.

In the wake of worsening problems linked to globalization, there is a growing perception that Mercosur is a good instrument to articulate a new form of international projection for South American countries. Despite some lingering uncertainties, few actors question the salient character of the process. So, at the same time that the decision-making mechanisms and the institutions essential for an adequate functioning of Mercosur are re-evaluated, issues such as the strengthening and the enlargement of the process emerge as important strategic question. Lastly, it is essential to meet the challenges of the hemispheric integration represented by the FTAA and of Mercosur's place inside it.

CHAPTER – IV

ARGENTINE ECONOMIC RISIS AND ITS EFFECTS ON MERCOSUR

In 2002, Argentina's economy suffered its worst crisis ever since 1891, culminating in an economic slump that began in late 1998. Argentina's crisis caused recessions in Paraguay and Uruguay and contributed to a slowdown of the Brazilian economy as Brazil and Argentina are major trading partners in Mercosur. Argentina is the latest example of many large developing countries to have suffered currency and financial crises since Mexico's crisis in 1994-95.[1] Argentina's experience has been used as evidence that freemarket economic policies lead to catastrophe, that fixed exchange rates do not work, and other such general propositions about economic policy. Box 1 lists some statistics of the crisis.

Box 1. A snapshot of the crisis (1998-2002)

- Real gross domestic product (GDP) fell 28% from peak (1998) to trough (2002).
- Argentina's currency, the peso, equal to US$1 since April 1991, was devalued in January 2002 and depreciated to nearly 4 per dollar before partly recovering.
- Inflation, low or negative since the early 1990s, reached 41% in 2002.
- Unemployment, excluding people working in emergency government relief programs, rose from 12.4% in 1998 to 18.3% in 2001 and 23.6% in 2002.
- The poverty rate rose from 25.9% in 1998 to 38.3% in 2001 and 57.5% in 2002.
- In real terms (that is, adjusted for inflation), wages fell 23.7% in 2002.
- In real terms, supermarket sales fell 5% in 2001 and 26% in 2002.

BACKGROUND TO THE CRISIS

Argentina's turbulent economic history. Argentina's recent difficulties are unusual only for their severity. The country has a history of chronic economic, monetary and political problems. After overthrowing the Spanish colonial government in a war of independence that began in 1810, Argentina's provinces fought among themselves. There was persistent political and economic tension

[1] Joint Economic Committee (2001, 2002a) discusses these crises and their causes.

between the more remote provinces and the pampa-the vast fertile plain whose hub remained the city of Buenos Aires. As a saying goes: "The city of Buenos Aires is richer than the rest of the pampa, and the pampa is richer than most of the rest of Argentina". No stable nationwide government existed until 1862. During the first half century of independence, the provinces and the national government often financed budget deficits by printing money. Argentina suffered persistent inflation, though economic growth was respectable.

In the late 1800s, Argentina experienced an economic boom based on rising exports of wheat and beef to Europe, made possible by the new technologies of railroads and refrigerator ships. Growth in real gross domestic product (GDP) per person accelerated to 2.5 percent a year from 1870 to 1913 – a rapid growth rate for the era. Growth was far from smooth and in 1890-91 Argentina suffered an economic crisis roughly the equal of the recent crisis. The crisis originated in the budgetary problems of Argentina's federal government.[2] In 1889, the government repaid some domestic debt not in gold, as it had promised, but in national currency not readily convertible into gold. The results were flight of investment from the country, bank failures, currency depreciation, default by municipal and provincial governments on their foreign debt, inflation, depression, and the resignation of the president. After a series of generally free-market reforms to tackle the problems, starting in the mid 1890s Argentina enjoyed about 20 years of renewed growth. Argentina attracted foreign investment, especially from Britain; received many foreign workers, especially from Italy and Spain; developed an industrial base in Buenos Aires and some other large cities; and became one of the world's richest countries. From 1902 to

[2] Rock David, "Racking Argentina", *New Left Review*, Sep. – Oct., 2002, pp 55-86.

1914 Argentina had a type of "currency board" monetary system, in which the peso had a fixed exchange rate with gold and all paper money issued by the government beyond a certain amount was backed 100 percent by gold or securities denominated in gold.

The outbreak of the First World War in 1914 disrupted world financial markets and badly hurt Argentina, which then abandoned the gold standard and the currency board system. Economic growth resumed in the 1920s. Argentina returned to the currency board system in 1927, but abandoned it in 1929 under the weight of what would develop into a worldwide depression.[3] In 1935, Argentina replaced its currency issuing bureau with the central bank it has had ever since. During the 1930s, when important trading partners discriminated against a largely closed, self-sufficient economy, with high tariffs and extensive government intervention. In the 1930s, this approach softened the effects of the Great Depression, but in later decades, it reduced economic growth.

Until the 1980s, military juntas often alternated in power with elected presidents. Economic problems provided pretexts for a number of military takeovers. Between 1916 and 1989, there were no transfers of power from a democratically elected president to a democratically elected president of another party. Juan Peron, who had become Argentina's best known president, came to power as part of a junta in 1944. He was elected president in 1946, 1951, and again in 1973.

During 1950s, Argentina experienced high inflation, ranging as high as 102 percent in 1959. Economic growth, expressed in terms of real GDP per capita, was less than 1 percent a year. Growth accelerated in the 1960s as Argentina

[3] Ibid.

tamed triple-digit inflation and participated in the booming world economy. In 1973, Juan Peron returned to Argentina after a forced exile of 18 years and was elected president. After he died in 1974, he was succeeded by his third wife, vice president Isabel Martinez de Peron. The Perons proved themselves as poor managers of economic policy. In 1975, annual inflation leaped to 335 percent. A junta seized power in 1976 from Isabel Peron. The junta tried to make economic reforms but never combined a coherent plan with the will power to persist with drastic changes. During this period the government fought a "dirty war" against guerilla groups. Thousands of Argentines died during the war, mostly as victims of the military. To divert attention from increasingly severe political and economic problems, in 1982 the junta ordered an invasion of the nearby Falkland Islands, A British territory that Argentina had long claimed. British forces counterattacked and took back the islands. In 1983, the junta transferred power to an elected civilian president, Raul Alfonsin of the Radical Civic Union party. But President Alfonsin was no more successful at solving Argentina's economic problems than the junta which had witnessed the extreme inflation caused by economic chaos and signaled the final collapse of the closed economy approach. President Alfonsin stepped down six months early in July 1989. The Justicialist (Peronist) party's Carlos Menem began governing subsequently.

President Menem's Economic Reforms, 1989-1994.

President Menem had campaigned on a vague, populist platform. After finding that its effects were bad, he switched to a free market approach that reduced the burden of government. Menem's policymakers started by privatizing, deregulating, cutting some tax rates, and reforming the state. In January 1991, Menem appointed Domingo Cavallo as his minister of economy. The centerpiece of Menem's policies was the Convertibility Law, which took effect on April 1, 1991.[4] It ended the hyperinflation by establishing a pegged exchange rate with the U.S. dollar and backing the currency substantially with dollars. As Cavallo explained a number of times, the idea of the Convertibility Law was to given holders of Argentine currency a property right to the dollars backing the currency-something they had not had in two generations. The exchange rate was initially 10,000 Argentine australes – US$1.[5] Inflation plummeted from 1,344 percent a year in 1990 to an annualized rate of 29 percent for the portion of 1991 during which the Convertibility Law was in force; it fell below 4 percent by 1994 and still lower in later year of the "convertibility" system. Argentines were allowed to use dollars freely, and the country developed a "bimonetary" system in which loans and bank deposits in dollars became widespread.

Reforms in Argentina were faster and deeper than in any country outside the former communist bloc. Table 1 below shows their results. Real GDP per capita rose more than 10 percent a year in 1991 and 1992, before slowing to a more normal rate of above 4 percent in 1993 and 1994. Argentina attracted massive foreign investment, which helped modernize its utilities, ports, railroads, banks, and other sectors. The major dark cloud of the period was the unemployment rate. From 1989 to 1999, the number of jobs grew as fast as the population, but the number of people who wanted to work grew even faster. Despite some changes, labor laws remained rigid and taxes on formal employment

[4] Law 23.928. The Law on Reform of the State (Law 23.696, 1989) was the other key law of the period.
[5] Starr. K. Pamela, "Argentina: Anatomy of Crisis foretold", *Current History*, Feb, 2003, pp. 65-76.

remained high, hampering creation of new jobs in the economy.[6] Some job seekers went to work in the widespread underground economy, which was more flexible but more precarious.

President Menem implemented many reforms by emergency decree rather than by the normal process of passing laws through Argentina's Congress. One reason for doing so was that even within Menem's Peronist party, there was strong opposition to many reforms. Some reforms, such as the privatizations of certain government-owned companies lacked transparency and retained elements of monopoly that benefited entrenched interests.[7] Corruption remained a problem, as it had been since the 1800s, and a large number of top officials in president Menem's government were later investigated for their activities. Even so, Argentina made progress in reducing the inefficiency-long characteristic of ordinary economic activity in the country. One example is that after the government telephone company was privatized, the average delay for installing new lines fell from months to a few days.

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[6] It was estimated that in the 1980s the combined effect of taxes imposed a marginal tax rate of 95 percent on income from labor. The marginal rate fell after tax reforms in 1989, but the basic rate of payroll tax remained high: it was 49 percent both in 1990 and 1998 (International Monetary Fund 2000, p. 24). However, starting in 1994, workers could choose whether to join a new system of private retirement accounts and pay 11 percentage points of wages into personal accounts, or remain in the government social security system and pay a tax of 11 percentage points of wages to it (Law 24.241).

[7] Gulati Mitu, "Restructuring Argentina's Debt: How is it Going to Happen?" *Economic and Political Weekly*, 37 (1), 2002, 5-11 Jan., pp. 30-31.

Table 1.

Argentina: Major Economic Indicators, 1989-2002

	1989	1990	1991	1992	1993	1994	1995
GDP, bn pesos	3.24	68.9	181	227	237	257	258
Population, mn	33.4	33.9	34.3	34.8	35.2	35.7	3.61
Pesos per dollar	0.18	0.56	1.0	1.00	1.00	1.00	1.00
Real GDP growth per head,%	-8.8	-3.7	11.2	10.5	4.5	4.4	-4.1
Inflation, CPI, %	4,923.5	1,343.9	84.0	17.5	7.4	3.9	1.6
Inflation, PPI, %	5,386.4	798.4	56.7	3.2	0.1	5.8	6.0
Employment, mn	12.2	12.4	12.7	13.0	13.1	12.8	12.5
Unemployment rate, %	7.1	6.3	6.0	7.0	9.3	12.1	16.6
Poverty rate, %	47.3	33.7	21.5	17.8	16.8	19.0	24.8
Industrial production, %	-7.5	-2.1	8.5	1.2	8.9	-0.3q	-5.1
Average wage, pesos/hour		1.00	2.49	3.18	3.58	3.77	3.90
Exports of goods, $bn, FOB	9.6	12.4	12.0	12.4	13.3	16.0	21.2
-to Brazil, $bn	1.1	1.4	1.5	1.7	2.8	3.6	5.5
Imports of Goods, $bn, CIF	3.9	4.1	8.3	14.9	16.8	20.1	20.1
- from Brazil, $bn	0.7	0.7	1.5	3.3	3.7	4.3	4.7
Current account, $bn	-1.3	4.5	-0.7	-5.7	-8.2	-11.2	-5.2
Capital account, $bn-g	-8.1	-5.9	0.2	7.6	20.4	11.4	5.0
Monetary base, bn pesos	0.5	3.6	7.8	11.0	15.0	16.3	13.8
Net FX reserves, $bn	-0.3	-0.6	8.4	11.8	11.8	9.9	13.5
Peso bank deposits, bn-d	0.5	5.6	11.3	18.1	25.3	28.4	27.2
US$ deposits, bn pesos-d	0.3	1.8	6.5	10.7	17.2	21.6	21.5
Peso deposit rate, %-t	7,963	32.61	21.41	10.95	8.98	11.14	9.18
Dollar deposit rate, %-t					5.64	6.35	7.48
Peso prime rate, %-k	3,579a	2,177a	161a	32a	10.43q	19.09	12.41
Dollar prime rate, %-k					8.16	11.88	10.93
Federal revenue, bn pesos	0.46	9.9	26.2	36.7	42.4	42.5	45.3
-spending, bn pesos	0.66	11.8	27.8	35.7	39.7	39.8	46.6
-budget bal., bn pesos	-0.20	-1.9	-1.2	1.0	2.7	2.7	-1.9
- debt, bn pesos		78.9	86.5	88.0	69.6q	80.7	87.1
-debt service, bn pesos	0.23	0.6	5.0	3.9	2.9	2.8	4.1
-country risk, %0.13	19.4a	21.0a	5.63q	10.26	3.70	11.41	8.75
Provincial rev., bn pesos-r	0.12	14.1	14.7	21.8	25.5	27.4	26.7
- spending, bn pesos	0.13	11.5	16.2	22.4	27.3	29.6	29.9
-budget bal., bn pesos	-0.02	-2.6	-1.5	-0.6	1.8	-2.2	-3.2
-debt, bn pesos							
-debt service, bn pesos	0.5	0.5	0.8	0.5	1.1	1.2	2.6
Total external debt, $bn	65.3	62.2	65.4	68.3	64.7	75.1	98.8

Notes: a = annual average; bn = billion; CIF- cost, insurance and freight CPI= consumer price index; d = December monthly average; e = estimate; FOB = free on board; FX = foreign exchange; g = includes financial account; h = 12.7 million counting government employment programs; i = 17.8% counting government employment programs; j = June; k = 30-day term; mn = million; n = November 30, last day before deposit free; PPI = producer price index; q = new series starts here; r = provincial revenue includes federal revenue sharing; federal revenue excludes revenue sharing; $ = U.S. dollars; t = 30- to 59-day term, u – 35.4% by old series, covering only greater Buenos Aires; v = 54.3% by old series. Blanks indicate consistent data are unavailable.

Continued

	1996	1997	1998	1999	2000	2001	2002
GDP, bn pesos	272	293	299	284	284	269	342
Population, mn	36.6	37.0	36.2	36.6	37.0	36.2	36e
Pesos per dollar	1.0	1.00	1.0	1.00	1.0	1.00	3.36
Real GDP growth/head,%	4.2	6.7	2.5	-4.6	-1.7	-7.0	-10.8e
Inflation, CPI, %	0.1	0.3	0.7	-1.8	-0.7	-1.5	41.0
Inflation, PPI, %	1.1	-0.8	-6.5	1.1	2.3	-5.6	125.2
Employment, mn	12.7	13.1	13.4	13.5	13.5	12.5	12.2e,h
Unemployment rate, %	17.3	13.7	12.4	13.8	14.7	18.3	23.6i
Poverty rate, %	27.9	26.0	25.9	26.7	28.9	38.3q,u	57.5v
Industrial production, %	4.9	9.1	2.2	-6.5	-0.3	-7.6	-10.6
Average wage, pesos/hour	4.03	4.07	4.12	4.16	4.23	4.29	4.60e
Exports of Goods, $bn, FOB	24.0	26.4	26.4	23.3	26.4	26.6	25.4
-to Brazil, $bn	6.6	8.1	7.9	5.7	7.0	6.2	4.7
Imports of Goods, $bn, CIF	23.8	30.5	31.4	25.5	25.3	21.0	9.0
- from Brazil, $bn	5.3	6.9	7.1	5.6	6.5	5.3	2.5
Current account, $bn	-8.2	-12.2	-14.5	-11.9	-8.9	-4.6	9.0
Capital account, $bn-g	11.8	16.8	19.1	15.0	8.6	-13.5	-11.4
Monetary base, bn pesos	14.1	16.0	16.4	16.5	15.1	17.8	29.1
Net FX reserves, $bn	16.9	20.8	20.8	22.8	21.9	14.5	10.5
Peso bank deposits, bn-d	31.2	38.8	41.6	40.4	38.7	25.0	79.8
US$ deposits, bn pesos-d	26.4	32.8	39.4	43.2	47.7	44.2	2.2
Peso deposit rate, %-t	7.61	8.71	8.44	6.80	11.10	12.78n	16.10
Dollar deposit rate, %-t	5.97	7.13	6.85	6.14	8.84	10.09n	1.29
Peso prime rate, %-k	10.45	12.33	10.74	13.81	14.80	54.86n	26.75
Dollar prime rate, %-k	8.82	8.69	9.31	10.29	13.19	32.78n	None
Federal revenue, bn pesos	42.1	49.1	50.1	48.9	46.1	40.5	39.4
-spending, bn pesos	47.4	53.1	53.9	54.0	52.7	49.0	44.0
-budget bal., bn pesos	-5.3	-4.0	-3.8	-7.1	-6.6	-8.5	-4.5
- debt, bn pesos	97.1	101	112	122	128	144	467
-debt service, bn pesos	4.6	5.8	6.7	8.2	9.7	10.2	6.8
-country risk, %0.13	4.94	4.61	7.07	5.33	7.73	43.72	63.03
Provincial rev., bn pesos-r	29.1	32.6	33.1	32.3	32.5	30.0	32.2
- spending, bn pesos	30.3	32.7	35.1	36.4	35.9	36.4	34.0
-budget bal., bn pesos	-1.2	-0.1	-2.0	-4.1	-3.3	-6.4	-1.8

-debt, bn pesos	13.9	11.8	13.2	16.6	21.3	30.1	64.3j
-debt service, bn pesos	3.1	3.3	3.0	3.0	2.9	2.4	1.5
Total external debt, $bn	111.4	128.4	141.4	145.3	146.2	165.2	134.3

Sources: *International Monetary Statistics* CD-ROM; World Bank, *World Development Indicators* 2002 CD-ROM;

Argentina and Financial Markets Crises-1995-1999: Mexico's currency devaluation of December 1994- the so-called tequila crisis- triggered fear that Argentina would devalue, even though economic links between the two countries were not very high and Argentina's "convertibility" system differed in important ways from Mexico's monetary system. Interest rates rose in 1995 until the government allayed fears of devaluation or default by securing a financial package from international financial institutions and private local investors.[8] Argentina suffered a sharp recession in 1995. In its wake, Argentina's federal government strengthened the financial system by closing or privatizing many poorly managed banks owned by provincial governments.

Growth returned in 1996 and 1997, but in mid 1998 Argentina felt the effects of currency crises in Russia and in Brazil. In a milder repeat of the 1995 crisis, interest rates jumped in Argentina. For 30-day loans in pesos, a benchmark indicator, the prime rate (the rate banks charge their best business customers) rose from below 8 percent a year in August 1998 to a high of 19 percent in late September. Argentina's economy went into recession by October.[9] Brazil overcame the 1998 crisis at the cost of economic stagnation, but in January 1999 it allowed its currency to depreciate considerably to revive growth. Brazil suddenly gained some export advantage over Argentina that was amplified within Mercosur.

[8] Mahon, E. Jomes Jr. and Corrales. Jarier, "Pegged for Failure? Argentina's Crisis", *Current History*, 101 (632), Feb. 2002, p. 72-75.

[9] Quarter-over-quarter growth was negative in the third quarter of 1998, while year-over-year growth became negative starting in the fourth quarter.

In Argentina, the prime rate in pesos rose to almost 16 percent in January 1999, but by that April it was back below 8 percent, where it had been before Brazil's crisis began.

President Menem made much effort during his second term in an unsuccessful attempt to change the constitution to allow him to run for a third consecutive term.[10] He tried to gain support for the constitutional change from special interest groups by not making economic reforms that would have benefited the majority of Argentines at some expense to special interests. In consequence, the pace of economic reform slowed. President Menem's government also committed an important mistake in 1999 by failing to follow private sector forecasters in reducing its estimates of tax revenue, even after it became apparent that the estimates were too optimistic.

THE CRISIS

Recession and President De la Rua's Tax Policy, 2000-2001. Fernando De la Rua became president in December 1999 as the head of the center-left Alliance coalition. He had promised to end the recession and fight corruption. The constituent parties of the Alliance, Frepaso (Frente Pais Solidario- National Solidarity Front) and De la Rua's Radical Civic Union, had widely differing ideas about economic policy. De la Rua's Vice President, the Frepaso leader Carlos Alvarez, resigned in October 2000 to express frustration with a slow moving bribery investigation and with economic policy. Table 2, lists some important events for Argentina beginning with president De la Rua's accession to office.

[10] Constitutional amendments of 1994 changed the term of the president from a single term of six years to a maximum of two consecutive four-year terms. As a transitional measure, president Menem was allowed to serve a four-year term under the new rules in addition to his six-year term under the old rules. After one term, a former two term president may run again for two more consecutive terms.

The De la Rua government was worried about the federal budget deficit, which was 2.5 percent of GDP in 1999. The government thought reducing the budget deficit would instil confidence in government finances, reducing interest rates and thereby spurring the economy, which was showing signs of recovery in late 1999. Among the options for reducing the deficit, cutting spending was politically difficult; the government had apprehensions that cutting tax rates would spur enough growth in the short term to offset lost revenues; it did not wish to abandon the convertibility system and simply print money; and it suspected that financial markets would be unwilling to finance higher debt, though the International Monetary Fund (IMF) did support Argentina with a loan in March 2000.

Table 2. Important Economic Events in Argentina since late 1999

1999: December 10	Fernando de la Rua, of the Alliance coalition, succeeds the Peronist Carlos Menem as president. Economy in recession since October 1998. Later in December, new government passes tax increases.
2000: March	IMF approves US$7.2 billion stand-by loan to Argentina.
October 6	Vice president Carlos Alvarez resigns, weakening the government.
December 18	IMF leads $40 billion loan package to Argentina.
2001: March	Three economy ministers in three weeks. Alliance coalition breaks up March 18. Domingo Cavallo appointed economy minister March 20, unveils plan March 21 to increase taxes.
April 17	Cavallo introduces bill to link peso to euro and dollar (enacted June 25).
April 25	De la Rua replaces "hard money" central bank president.
June 3	Debt swap of $29.5 billion
June 15	Cavallo announces preferential exchange rate for exports.
July 11-26	Bond rating agencies downgrade Argentine govt. debt (also Oct. 9-11).
July 30	Congress passes "Zero deficit" law, making more tax increases.
Aug. 21-Sept.7	IMF increases $14 billion stand-by loan to $22 billion.
October 14	Opposition Peronist party wins midterm congressional elections.
November 1	New measures, including swap for most of $ 132 billion public debt.
November 30	Overnight interest rates in pesos average 689% on fears of devaluation and deposit freeze. Bank run.
December 1	Cavallo announces bank deposit freeze.
December 5	IMF cuts off lending.
December 13	General strike. Riots and looting follow.
December 19-20	Cavallo and then De la Rua resign.
December 20-31	Interim presidents Ramon Puerta, Adolfo Rodriguez Saa, and Eduardo Camano. Rodriguez Saa defaults on foreign debt December 23.
2002: January 1	Peronist Eduardo Duhalde chosen president by Congress
January 6	Law of Public Emergency and Reform of the Exchange Rate Regime ends "convertibility" monetary system in effect since 1991.
January 9	Peso devalued to 1.40 per dollar for certain transactions, floated for the rest. Bank deposits "pesofied" at 1.40 pesos per dollar, loans at 1.00.

February 11	Foreign exchange market fully reopens; peso falls to around 2 per dollar.
April 22-5	Bank holiday. Economy minister Jorge Remes Lenicov resigns April 25.
August-September	Severely depressed economy shows signs of having reached bottom.
November 14	Argentina defaults on debt to World Bank.
December 2	Deposit freeze ends for checking and savings accounts, after having been loosened but not removed for time deposits on October 1.
December 26	Foreign exchange controls relaxed; further relaxed January 8,2003.
2003: January 17	IMF announces it will renew Argentina's outstanding loans.
March 5	Argentine Supreme Court nullifies "pesofication" of certain deposits.
May 25	Peronist Nestor Kirchner becomes president following elections.

Source: http://www.house.gov/jee

Under the circumstances, the government was left with one option i.e., raising tax rates. President De la Rua secured approval for three big tax increases, effective January 2000, April 2001, and August 2001.[11] The increases came on top of already high tax rates. The highest rate of personal income tax, 35 percent, was near the level of the United States, but the combined rate of federal payroll tax paid by employer and employee was 32.9 percent as against 15.3 percent in the United States; the standard rate of value-added tax was 21 percent compared to state sales taxes of 0 to 11 percent in the United States; and Argentina imposed taxes on exports and from April 2001 on financial transactions. Argentina's high tax rates encouraged tax evasion: an estimated 23 percent of the economy is underground and 30 to 50 percent of all transactions evade taxes.[12]

The economy continued to shrink in 2000, although at a slower rate than it had in 1999. Political problems resulted. Minister of economy Jose Luis Machinea resigned his position on March 9, 2001. His successor, Ricardo Lopez Murphy, proposed to strengthen the finances of Argentina's federal government by cutting spending 4.5 billion pesos over two years- less than 1 percent of GDP a year. The proposed cuts were deeper than any the De la Rua government on 18 March, 2001

[11] Argentina, Law 25.239, Law 25.413 (the Competitiveness Law), Decree 380/2001, and Decree 969/2001. The other key law of this period was Law 25.453 (the Zero Deficit Law). There had also been some tax increases under president Menem in April 1995, August 1996 and December 1998. The April 2001 package included subsidies intended to offset much of the tax increase.

[12] Teldstein Martin, "Argentina's Falls Lessons from the Latest Financial Crisis", *Foreign Affairs*, Mar-April. 2002, pp. 8-24.

to express their opposition to cuts. Lopez Murphy was then forced out after barely two weeks on the job.

Monetary and Debt Policy, 2001. President De la Rua then appointed Domingo Cavallo, the leader of a small political party, as minister of economy. Since quitting as Carlos Menem's minister of economy in 1996, Cavallo had more than once talked about changing the convertibility system.[13] On 17 April, 2001 he introduced a bill to switch the exchange rate link of the peso from the U.S. dollar alone to a 50-50 combination of the dollar and the euro. At the time, the dollar was at its strongest level in about 15 years, and its strength led Argentine exporters and businesses competing with imports to complain that the peso was too strong. Investors interpreted the proposed switch as a possible step toward devaluation. Short-term interest rates immediately jumped, and a "silent run" on banks began. Also in April 2001, president De la Rua replaced the president of the central bank with a more pliable official.

On June 15, Cavallo announced a preferential exchange rate for exports- a type of favoritism contrary to the spirit of the Convertibility Law and to Argentina's agreements with the IMF. On June 21, Argentina's Congress approved switching the exchange rate link of the peso. The law provided that the switch would not happen until the value of euro presently worth 90 cents, appreciated to $1 (which of course occurred in July 2002).

In elections of 14 October, 2001, worsening of the economy helped the opposition Peronist party win a majority of seats in both houses of Argentina's Congress. Also, the Radical former president Raul Alfonsin and the Peronist former vice president Eduardo Duhalde won election as senators. Both were

[13] Fanelli, Moria, *"Growth, Instability and the Crisis of Convertibility in Argentina"*, www.fondad.org.

outspoken critics of the reforms of the 1990s and personal rivals to president De la Rua. The election created a political deadlock that further worsened the outlook for Argentina. President De la Rua was unable to secure approval for legislation he favored, but he could veto bills making many of the changes in economic policy that his successor implemented.

During 2001, bank deposits came downward after reaching an all-time peak at the end of February of that year. Interest rates moved upward on March 19, the first business day after cabinet ministers of the Frepaso party resigned and hit president De la Rua's coalition government. After settling down a bit, rates began climbing on June 15, when Cavallo had told a French newspaper that Argentina would one day cease to link the peso to the dollar[14] and international bond rating agencies had downgraded the government's credit rating. Further increases occurred in early November, when Cavallo announced a series of new measures to combat the government's financial problems, and late November, when people (correctly) feared a freeze of bank deposits. The freeze, imposed on December 1, temporarily ended lending in pesos, although some lending in dollars continued.

Meanwhile, the government refinanced much of its debt at higher interest rates on June 3 and November 1, 2001. The debt swaps reduced debt repayments in the short term at the cost of higher repayments later. The swaps were quasi-compulsory for local financial institutions, and loaded them with more government debt, in less liquid form, than they really wanted.[15] The government also secured further loans from the IMF in January and September 2001. The total

[14] Agence France Presse (2001), summarizing an interview in *La Tribune*.

[15] There was also a refinancing on July 31, 2001 for 1.3 billion pesos. A sale of $2 billion in bonds on April 11, 2001 caused concern because the government let banks count as reserves the bonds they purchased.

of about $22 billion that the IMF approved for Argentina in 2000 and 2001 was the largest amount for any country up to that point. (Like most other IMF loans, these loans were disbursed in installments, so Argentina could not borrow all the funds immediately.) The September 2001 loan, announced in August, was especially controversial because Argentina's debt problems were by then so severe that many observers[16] thought a loan would only delay changes in policy necessary to restore economic growth.

The Upheavals of December 2001. Having lost confidence in the peso, people started withdrawing their deposits and government responded with a freeze on bank deposits in December 2001.[17] The economy turned from recession to depression as people and businesses could not make payments. Credit evaporated. Argentines remembered how high inflation had deprived them of the real value of their savings during a similar freeze in 1989 and in a 1992 freeze engineered by Cavallo himself. Many people took to the streets and burst out in angry demonstrations, damaging public property.

On December 5, the IMF announced it would cease making further installments of the loan it had approved in September, because Argentina was not fulfilling the targets of the loan agreement. Argentina by now had little chance of receiving loans from any foreign source. A general strike occurred on December 13, and looting and protests on December 19-20 resulted in 24 deaths. Cavallo resigned on December 19 and De la Rua followed on December 20.

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[16] Ranging in the United States from the liberal economist Morris Goldstein (2001), a former IMF official, to the conservative economist Charles Calomiris (2001), who have proposed drastic reforms to the IMF.

[17] Decree 1570/2001; Banco Central de la Republica Argentina, Communication "A" 3372. Regulations initially limited withdrawals to 250 pesos a week. Andrew Powell (2003), who was chief economist of Argentina's central bank from 1996 to 2001, identifies the trigger for the run as the central bank's Communication "A" 3365 of November 26, which limited interest rates on new deposits.

The interregnum of three presidents in less than two weeks was notable for two events. One was the switch of party control of the presidency to the Justicialist (Peronist) party, where it has remained since. The switch occurred because the post of vice presidency was vacant, so Argentina's Congress, controlled by the Peronists, chose the president. The other big event was president Abolfo Rodriguez Saa's decision of 23 December, 2001 to default on the government's $50 billion debt to foreign private sector lenders. The default proved popular within Argentina, but Rodriguez Saa resigned a few days later after his government's failings in domestic policy prompted a new round of protests.

President Duhalde's New Economic Policies, 2002. To serve the rest of former president De la Rua term, Argentina's Congress then chose as president Eduardo Duhalde, who had been the runner-up to De la Rua in the 1999 presidential election. From 1991 to 1999, Duhalde had been the governor of Buenos Aires province, the richest and most populous in the country. He was ranked as big spender.[18] He assumed the presidency determined to reverse those policies- in particular convertibility system-because he thought they had caused the recession. For several years, the convertibility system had received growing criticism. The dominant view among economic observers inside and outside Argentina was that the peso's one-to-one exchange rate with the dollar had made the peso overvalued, making Argentine exports non-competitive and preventing an export-led economic recovery.[19] Staff of the IMF shared this view, which later sections will argue lacked solid supporting evidence. Under the Law of Public Emergency and Reform of the Exchange Rate Regime (January 6, 2002) and

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[18] Fiszbein Ariel, Gioragnoli, Paula Ines and Aduriz Isidra, "The Argentine Crisis and its impact on household welfare", *CEPAL Review*, 79, April, 2003, pp. 143-158.
[19] http://www.house.gov/jee/

related measures,[20] the government: ended the convertibility system, in effect confiscating $14.5 billion of foreign reserves that under the convertibility system were held in trust for the Argentine people and other holders of pesos; devalued the peso from the previous rate of 1 per dollar to 1.40 per dollar, and later floated the exchange rate, allowing further depreciation' forcibly converted dollar bank deposits and loans into pesos ("pesofication"). Deposits were converted at 1.40 pesos per dollar; loans, at 1 peso per dollar. Interest rates were frozen at predevaluation levels. Since the market exchange rate was 2 pesos per dollar at the time, the cost to bank depositors was about $23 billion; the net cost to banks from devaluing loans more than deposits was a further $12 billion.[21] And forced prolonged time deposits. (The Spanish name for this measure is the *corralon*, or big corral, to distinguish it from the earlier *corralito*).

The government also "Pesofied" contracts in dollars at 1 peso per dollar, with large though unquantified costs for creditors; seized the dollar reserves of banks, costing them about $1.6 billion; imposed exchange controls (restrictions on buying foreign currencies); Suspended bankruptcy proceedings; doubled penalties for employers who laid off employees; and established a variety of new taxes and regulations, introduced in uncoordianted fashion and frequently revised.

In addition to these policies, the Duhalde government tried to enact, or enacted and then reversed some of other policy measures just as swapping. For example, the government sought but failed to obtain the support of Argentina's Congress for a forced conversion of many bank deposits into government bonds.

[20] Argentina, Law 25.561; Decrees 71/2002, and 471/2002; Ministry of Economy, Resolutions 6/2002 and 11/2002; Banco Central de la Republica Argentina, Communications "A" 3661 AND 3722.

[21] Law 25.713 of November 28, 2002 indexed interest rates for inflation starting February 3,2003, but lenders received no compensation for inflation that occurred while interest rates were frozen. When the last phase of unfreezing deposits began in April 2003, at the range of exchange rates then existing, depositors in dollars could recover 80 to 85 percent of the original value of their deposits. By this measure, the net cost of pesofication to depositors was roughly $9 billion.

Minister of economy Jorge Remes Lenicov resigned on 23 April, 2003 after it became clear that the Congress would not pass the bill. The government also enacted certain bankruptcy provisions that would have given creditors a free ride, but reversed the provisions under pressure from the IMF.

The Duhalde government's policies reversed the often erratic but persistent trend of the previous quarter-century toward less government direction of the economy, greater respect for property rights, and more predictable policies. The government took tens of billions of dollars of wealth from the public, and transferred tens of billions more from some groups among the public to others-notably from creditors to debtors. (Such transfers do not seem to have made the distribution of wealth more equal. Individual bank depositors-who are generally from the middle class, witnessed the real value of their savings falling in dollar terms, while many rich people and corporations that borrowed from banks benefited. (Poor people in Argentina typically neither have bank deposits nor owe bank loans).

Articles 14 and 17 of Argentina's constitution guarantee the right to private property and require the government to compensate property owners for taking over their assets. On 5 March, 2003, Argentina's Supreme Court ruled in a landmark case that the pesofication of a bank deposit had been unconstitutional. The Duhalde government stated that it would not try to craft a response to the court's ruling that is both legally and economically sound; rather, it left the task to its successor, who took office on May 25, 2003.

Results of the New Policies and Outlook for 2002-2003. Argentina's economy shrank 5.5 percent in 2001 and a further 10.9 percent in 2002. The unemployment rate rose to 23.6 percent (17.8 percent if one counts as employed people working in emergency government relief programmes). In 2002, real (inflation-adjusted) wages fell 23.7 percent, supermarket sales fell 26 percent, sales of new automobiles fell 53.4 percent, and construction activity fell 28.1 percent. The proportion of Argentines below the officially defined poverty line jumped from 38.3% in October 2001 to 57.5 percent a year later.[22] It is estimated that about 40 percent of Argentines live on $1 or less a day, and a further 20 percent on $1 to $2 a day. Malnutrition turned out to be as many as a problem, 18 children died of it during 2002 in the northwestern province of Tucuman alone.

Bankruptcies reached record levels in 2002. A wave of defaults or liquidity problems at some of Argentina's largest companies began in March 2002. Among the companies affected were the utilities such as Metrogas, Telecom Argentina, and Aguas Argentinas, along with Argentina's largest locally owned private sector bank, Banco Galicia. Foreign banks and utility companies operating in Argentina incurred large losses as a result of the Duhalde government's economic policies. They included the American banks such as Bank of America, Citigroup, FleetBoston Financial, and J.P. Morgan Chase & Co, as well as the utility companies AES Corporation, CMS Energy, Public Service Enterprise Group (PSEG), and Sempra Energy.[23] Companies from Spain, Italy, France, and Brazil were also affected. Banks suffered from the asymmetric way the government enacted pesofication. Converting bank liabilities from dollars into pesos at a 1.40

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[22] Statistics are from Argentina's *Instituto Nacional de Estadistica y Censo*, except for automobile sales, which are from the *Asociacion de Fabricas de Automotores*. The government collects statistics on poverty on twice a year, in May and October.

[23] Corporate 10-K and 10-Q forms filed with the Securities and Exchange Commission detail the following losses from operations in Argentina: Bank of America, $267 million in 202; Citigroup, $235 million in 2001 and $1.704 billion in 2002; FleetBoston Financial, $1.1 billion in 2001 and $1.3 billion in 2002; J.P. Morgan Chase & Co., $140 million in 2001 and no more than $100 million in the first nine months of 2002; AES Corporation, $134 million in the first nine months of 202; CMS Energy, $430 million in the first nine months of 2002; Public Service Enterprise Group (PSEG), $623 million in 2002; and Sempra Energy, $155 million in 2001 and $223 million in 2002. Except for AES Corporation, all losses are before taxes.

pesos per dollar, while converting assets at only a peso per dollar, wiped out much of banks' capital. The Canadian-owned Scotiabank Quilmes, the French-owned Credit Agricole, and the Italian-owned IntesaBci left Argentina rather than inject more capital to compensate depositors for the losses the government had inflicted.[24] Utility companies suffered from the pesofication of contracts that had been denominated in dollars. Utilities had brought equipment from abroad to expand Argentina's telephone, electrical, gas, water, and sewer systems. They had paid for the equipment in dollars or other foreign currencies, perhaps or credit. They were counting on recovering their investment from the increased revenue generated by more users. Contracts with the government specified that utilities could set prices in dollars, as security against depreciation of the peso. The Duhalde government voided the contracts.

An economic recovery began about August 2002.[25] It was initially fragile, but since then, it gained strength. The exchange rate, which depreciated to almost 4 pesos per dollar in mid 2002, appreciated to 2.90 pesos per dollar as of early June 2003. In 2002, inflation calculated at consumer prices (CPI) was 41 percent. The rate of inflation was much lower than the rate of depreciation of the peso partly because the economy was so depressed that sellers could not raise prices without losing sales, and partly because utilities were subject to price control. The producer price index, which has fewer goods subject to price controls, rose 125.2 percent. Still, unlike the last severe bout of currency depreciation in 1989, inflation did not go out of control. In 2003, inflation in consumer prices was

[24] The government has offered banks some compensation in the form of government bonds, which at present can only be sold at a large discount; see Decrees 905/2002 and 2167/2002.

[25] On a quarter-over-quarter basis the economy began growing in the second quarter of 2003, but on a year-over-year basis it shrank every quarter of 2002. Preliminary estimates are that in the first quarter of 2003, the economy grew 2.4 percent on a quarter-over-quarter basis and 5.2 percent on a year-over-year basis.

expected in single digit. Many sectors started expanding production. On 2 December, 2002 the government removed the carralito, the part of the freeze on bank deposits that applied to demand and savings accounts. At the end of 2002, total peso bank deposits were 66.5 billion pesos, of which 43 billion pesos were frozen. (In addition, there were $872 million in dollar deposits.) The government partly relaxed the corralon, the part of the freeze applying to time deposits, on January 15, 2003, which ended it on April 1.[26]

WHAT CAUSED THE CRISIS

Major factors leading to the Argentina's crisis included massive external debt and debt service obligations; high fiscal deficit; overvalued exchange rate and stagnant exports resulting into loss of output, employment and income[27]. Apart from these there are several major explanations for Argentina's crisis. Among the explanations for the crisis that have achieved some popularity are those that blame corruption; the failure of market-oriented economic policies; Argentina's supposed currency board monetary system; the overvaluation of the Argentine peso; and lack of budgetary discipline at the national or provincial level. All of these explanations locate the policies most responsible for the crisis as originating in the mid 1990s or before.

Corruption: Argentines and foreigners alike have complained about pervasive corruption since the 1800s.[28] The corruption of the 1990s does not seem

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[26] Ministry of Economy, Resolutions 6/2002, 668/2002, and 236/2003; Banco Central de la Republica Argentina, Communication "A" 3827; Argentina, Decree 739/2003.

[27] Chawla R. L. and Chatterji, Miniya, "Recent Economic Crisis in Argentina: A Perspective". *India Quarterly*, vol. 58, No.2,2002, (April-June), pp. 149-72.

[28] An English observer writing in 1899 remarked, "Argentina is one of the most unfortunate victims of parliamenteering run wild. It is not governed by administrators, but by professional politicians. Everything in its national life, whether industrial, commercial, or financial, begins and ends in Politics".

unusually high by historical standards. And rather than moving in the same direction, as one might expect, transparency and economic growth have moved in opposite directions every year except 2002.[29] This does not mean transparency is bad and corruption is good for Argentina's economy, but it does suggest that corruption was not the main cause or even a secondary cause of the crisis.

Failure of 'Free Markets' Syndrome: The crisis has also been blamed as a result of introducing free market economic policies too fast, two wide, and too rigid. In the 1990s, Argentina was regarded as a star pupil of the "Washington Consensus" of reforms promoted by the IMF, World Bank, and U.S. government. The Washington consensus reflected mainstream economic thinking in advocating monetary and budgetary discipline, a broad range of deregulatory measures, and privatization of many government activities. Crisis of the consensus have dubbed it, or their exaggerated version, of it, "market fundamentalism" or "neliberalism" (from the 19th –century sense of "liberal" still common in Latin America, meaning in favour of limited government).[30]

The "Currency Board": Still another explanation of the crisis faults Argentina's convertibility system, which was supposedly a currency board. The convertibility system maintained a pegged exchange rate of one peso per dollar. The peso supposedly became overvalued because, converted into dollars, prices in Argentina rose faster than prices in the United States and in Argentina's neighbours, notably Brazil. After Brazil devalued in 1999, the convertibility system prevented Argentina from devaluing to remain competitive; to end its recession, Argentina supposedly had to take the slower, more painful, and

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[29] Transparency International (2002). Another indicator, the Opacity Index (201), ranked Argentina 18th of 35 countries surveyed. (2002) and Organization of American States (2003).
[30] Clairmont, F. Frederic, "Argentina: Implosion of Neo-liberalism", *Economic and Political Weekly*, Mar. 30, 2001, pp. 1196-1198.

politically harder path of cutting wages. Ultimately that proved impossible, so Argentina had to devalue the peso.[31] The key questions about this explanation are whether the convertibility system of April 1991 to January 2002 was really a currency board, and whether the peso was in fact overvalued.

Analysis of the historical performance of currency board system worldwide strongly suggests that the convertibility system broke down not because of its currency board features, but because of the central banking features that an orthodox currency board would not have had. Argentina is the only country place where a currency board or currency board-like system has even ended in devaluation, out of about 80 countries that have had such systems. During the existence of the convertibility system, a few observers warned that its central banking features were a potential source of trouble. They proposed converting the system into an orthodox currency board or even replacing the peso with the dollar. They based their analysis on ideas from economic theory about differences in the way the money supply works under different kinds of monetary systems.

An Overvalued Peso: Evidence from various calculations and models that try to measure overvaluation of a currency is mixed. It is not warranted here to discuss and examine in detail those models and their methodologies. Adopting a simpler way of measuring overvaluation, that is to observe whether a central bank, currency board, or other monetary authority maintaining a pegged or fixed exchange rate with a foreign currency honours all demands to exchange local currency for the foreign currency. An orthodox currency board never has an overvalued currency in this sense, because it always keeps net reserves of 100

[31] Szusterman Cella, "More than a Crisis", *The World Today*, Feb. 2002, pp. 19-21.

percent or slightly more of its monetary liabilities. Under the convertibility system, Argentina's central bank allowed people to exchange pesos for dollars freely until December 2001, which not by coincidence was when its ratio of net foreign reserves to monetary liabilities fell below 100 percent. (The preferential exchange rate offered to exporters beginning June 2001 was a discriminatory exchange rate, but not a general restriction on exchanging pesos for dollars. In terms of its effects, Argentine overvalued currency had far-reaching impact on its domestic inflation, foreign trade and Balance of payment , employment, GDP and other macro indicators. For example, Buenos Aires was expensive for tourists. It was less expensive for natives, because they took the $1.30 bus rather than the $35 taxicab ride from the airport (which is about 20 miles from the city center); ate in modest neighborhood restaurants rather than nationally known establishments; and lived in outlying areas rather than staying in hostel downtown. Some comparisons of living costs in big cities around the world suggested that Buenos Aires was unusually expensive given Argentina's standard of living, while others did not.[32] For example, in 2000 taxis were 8 percent more expensive per mile in Rio de Janeiro than in Buenos Aires. And the *Economist* magazine's tongue-in-cheek Big Mac index, which compares the prices of McDonald's hamburgers around the world, suggested that the peso was 2 percent *undervalued* relative to the dollar in early 2001.

Federal Finances and Provincial Financing: Argentina's ratio of government debt to GDP increased in the mid 1990s, but much of the increase came from converting contingent liabilities into explicit liabilities. This dynamics of Argentina's government debt became a big problem in 2001. The experience of

[32] Because of different weighting criteria, the Economist Intelligence Unit ranked Buenos Aires the 18th most expensive of 133 cities in 2000, while the Swiss bank UBS (2000, p.6) ranked it 22nd of 58 cities.

Argentina, Brazil, and some other countries in the last few years suggest that the level at which government debt can become dangerous in developing countries is lower than almost all observers once suspected. But in 1998, and even as late as 2000, Argentina's debt did not seem unsustainable, even though its high ratio of external debt to exports worried some observers.

The question arises how important provincial finances were in causing the economic crisis. Reflection suggests they were also a contributory factor. Provincial deficits and debt, like federal deficits and debt, increased during the economic slump that began in 1998. (1) Loans from Federal government and foreign governments, agencies, institution (guaranteed and non-guaranteed by federal government) Non-repayment of principal plus non-payment of interest to fed government, increases it fiscal deficit and provinces ask for more loans to repay their debt in case of mismatch between their revenue and expenditure. (2) Non-payment of interests to foreigners brings the country to a default position. It is serious when these loans carry sovereign guarantee. No more credit is available in the international money/capital markets. (3) In case of Brazilian crisis of 1998-99, default on states loans triggered the crisis as foreign investors suspected the high federal fiscal deficit, causing the currency overvalued, high trade deficit or so. Assuming provincial debt to be implicitly a form of federal debt makes the trend of federal debt worse starting in 1998. But if the provinces had maintained balanced budgets, the severity of the crisis would not have that much. Further, as later sections explain, the federal government's failures in economic policy deepened the shrinkage of the economy reducing tax revenue and widening the fiscal deficits.

WHY THE CRISIS OCCURRED

Having reviewed why some frequently suggested explanations for Argentina's crisis are unsatisfactory, it is time to attempt a summery explanation that fits the facts better. Box 2 summarizes the proposed idea, which locates the policies most responsible for the crisis as originating during the period from late-1999 to early 2002.

Box 2: A Summary Explanation of Argentina's Crisis (1998-2002)

- Fallout from currency crises in Russia and Brazil triggered a recession in Argentina by October 1998.
- Tax increases implemented by President Fernando De la Rua, passed in December 1999 and effective January 2000, ended an imminent recovery.
- Divisions over economic policy led to a split in President De la Rua's coalition government on March 18, 2001. This was the start of the true crisis phase. Domingo Cavallo, appointed minister of economy after the split, made changes to the monetary system in April and June 2001 that reduced confidence in the peso and pushed up interest rates. He also helped obtain further tax increases in April and August 2001.
- These policies prolonged the recession. After ratings agencies reduced the government's credit rating in July 2001, the interest rates it had to pay became too high for it to sustain for long- a "debt trap".
- In December 2001, economic policy entered a phase in which the government "contaminated" the private sector. The contamination included a freeze on bank deposits under president De la Rua; incoherent proposals by president Adolfo Rodriguez Saa, who defaulted on the government's foreign private sector debt; and devaluation of the peso plus other emergency measures by President Eduardo Duhalde in January and February 2002. The economy shrank further, reaching bottom around August 2002, GDP was 28 percent below the peak of 1998.

REPERCUSSIONS OF ARGENTINE ECONOMIC CRISIS IN MERCOSUR

The prolonged 1998-2002 economic recession in Argentina had several negative consequences for Mercosur. **First**, it was a severe below for intra-Mercosur trade and investment, aggravated by Brazil's recession after its devaluation of January 1999. Intra-Mercosur exports as a share of total Mercosur exports went down from a 25% high in 1998 to only 11% in 2002. Further, Brazilian exports to Argentina fell by more than 60% in 2002; its imports from Argentina fell by about 26%[33]. **Second**, despite the recession, the De La Rua administration remained committed to the fixed parity of the peso with the dollar established by the Menem administration in 1991.[34] **Third**, as the gap between Argentina's fixed exchange rate and Brazil's periodic currency devaluation threatened Mercosur's survival, the anti-devaluation coalition ruling Argentina openly favoured dollarisation and favoured striking a deal with the USA to reverting Mercosur to a free trade area and even abandoning the Mercosur common market project. This posture no doubt, exacerbated trade disputes with Brazil, while the insistence on maintaining a fixed exchange rate with the dollar made macroeconomic harmonisation with Brazil impossible to achieve.

Fourth, the implosion of the Argentine economy in December 2001 reopened the debate on Mercosur's viability within the broader context of the FTAA negotiations. Most analysts feared that the Argentine crisis would have a negative impact on Mercosur, and that a populist regime in Argentina could harm Brazilian companies with investments in that country. A weak Argentina meant a weaker Mercosur, damaging Brazil's negotiating strategy for the creation of a

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[33] IADB, 2001:4; IADB, 2002:1.

[34] Carranza E. Mario, "Mercosur and the end game of the FTAA negotiations: challenges and prospects after the Argentine crisis", *Third World Quarterly, Vol. 25, No. 2, 2004, pp. 319-337.*

Free Trade Area of the Americas. A continuation of Argentina's economic slump threatened to slow down the Mercosur process, as intra-group trade stagnated and Argentina's partners sought alternative markets for their exports. Uruguay was particularly affected by Argentina's slump.

While Argentine crisis had adverse economic consequences for the Mercosur in terms of lost trade, currencies mismatch and declining GDP, employment and per capita income, this did have nevertheless a positive political impact on Mercosur. The lukewarm attitude of US leadership to deal with the crisis strengthened political solidarity among the Mercosur partners. In early 2002, there was talk of reviving Mercosur as a trading bloc and even of moving towards a common currency. In February 2002, at an extraordinary Mercosur summit meeting in Buenos Aires, the presidents of Brazil, Uruguay, Paraguay, Bolivia and Chile, promised total support for Argentina and asked the international financial institutions to understand the complex Argentine situation and provide the financial aid required by the Duhalde government to implement its recovery programme.[35]

Despite the lack of US support for an IMF rescue package when it was badly needed in 2002, the Argentine economy rebounded and was expected to expand around 4% to 6% in 2003. The January 2002 Argentine devaluation eliminated the main source of trade conflicts between Argentina and Brazil and since then both countries have been on their way to achieving macroeconomic convergence. The Argentine peso and the Brazilian real have similar exchange rates in relation to the dollar and both countries hope to keep them within a fixed band as the first step towards monetary union. Following the election of Nestor

[35] Ibid., pp. 326.

Kirchner as president of Argentina, the two countries are poised to have close political and economic relationship, which bodes well for strengthening Mercosur's position in the final stage of the FTAA negotiations.

CHAPTER – V

SUMMARY AND MAIN CONCLUSIONS

The 1980s witnessed not only the end of the cold war and the eventual dismantling of the Soviet Union, but also far-reaching political and economic changes across Latin America. While in 1980s authoritarian rule was the norm in most countries in the region, by the end of the decade some countries like Argentina and Brazil witnessed the revival of constitutional democracy. Further, these two former adversaries began the process of moving towards political accord with closer economic engagements. During the late 1980s, the world economy also moved increasingly towards regional economic groupings. The rapid spread of regionalism has been one of the most important recent developments in the global trading system.

Growing integration through unilateral liberalization, adherence to multilateral codes and regional trade arrangements has been (with of course, macroeconomic adjustment and the redefinition of the role of the state), one of the pillars of Latin America economic reforms. In keeping with this trend, Mercosur was created on 26 March 1991 in Asuncion by Argentina, Brazil, Paraguay and Uruguay. Mercosur initially targeted a free trade zone, then a customs union and finally, a common market. Its main objectives have been: to allow free movement of goods, services and factors among the member states by eliminating customs duties and lifting non tariff barriers (NTBs); to fix a common external tariff (CET) and adopt a common trade policy; to coordinate macroeconomic and sectoral policies in order to ensure free competition.

The Asuncion Treaty was reformed by the 1994 protocol of Ouro Preto, which has given Mercosur an international legal status, allowing it to negotiate with other countries and supranational bodies. Mercosur is a union of nation states, with a minimum of supranational institutions, such as Common Market

Council, Common Market Group, Trade Commission, Socio-economic Advisory Forum, Joint Parliamentary Committee and Secretariat Decision-making is usually by consensus.

One of the principal objectives of Mercosur is precisely to exploit potential welfare benefits of an economy wide programme of reform and market liberalization. By broadening the scope of liberalization, economy-wide and with free trade area for goods and services, embedded in a lowering of common external tariffs, Mercosur explicitly seeks to deliver greater competition and efficiency through 'open regionalism'. Closely tied to efforts to maximize welfare and promote open regionalism is the issue of industrial policy. Industrial policies of member countries encompass the combined effect of government policies designed to affect the allocation of resources among economic activities and produce an outcome different from what otherwise would have occurred by the market forces. Such policies could include tax exemptions or reductions for specific industries, selective credit control, concessional loans or administered trade protection measures such as anti-dumping measures and countervailing duties.

The contribution of trade liberalization and economic liberalization in general within Mercosur has led to rapid trade expansion. Our study shows the increasing importance of Mercosur markets for all four member countries. For example, in 1984-86 less then 10 percent of Argentine exports went to Mercosur compared with 30 percent by 1994. Although the 1984-86 level was lower (about 5 percent), a threefold increase also occurred for Brazil's exports to Mercosur (almost 14 percent in 1994). While Uruguay's share of exports rose almost 20 percentage points, reaching almost 47 percent in 1994. For all member countries together, the 1994 share of exports to Mercosur (reaching 20 percent) was almost three times the corresponding 1984-86 levels.

The impact of the creation of Mercosur has also been reflected in the increasing flow of intra regional investments. Macroeconomic stability in Argentina, together with revival of economic growth seen in the last four years in this country, has created incentives for both investors in the sub region and multinational corporations. The share of Mercosur member countries in global foreign direct investment (FDI) inflows increased five times in a decade. One of the keys to the process of growth described was the sharp increase in foreign trade volumes. Between 1990 and 1997, Argentine exports of goods doubled in value-marking an average annual growth of 10.9 percent. On the other hand, imports grew from US $ 4.1 billion in 1990 to US $ 30.4 billion in 1997 -ranking Argentina among the countries that have experienced the largest rise in imports in recent years.

The future of Mercosur depends heavily on the convergence of interests between Argentina and Brazil. If the two nations can overcome their trade conflicts, Mercosur will consolidate itself to the point of becoming irreversible. In the ultimate analysis, the neighbours will have to decide what model of Mercosur is in their best interest: the Brazilian model of autonomous industrialization and sustainable integration, or the model of dependent integration and alignment with the United States that Argentina followed during the Menem and de la Rua administrations.

In the aftermath of the 9/11 event, the Latin American economies suffered an abrupt downturn, worsening Argentina's four year long recession and creating fears of a long-term slump in the region. In that context, Argentina and Brazil realized that they can only succeed by clinging together while preserving Mercosur as a "strategic alliance". Their fate has become increasingly linked. Both visualised their inability to have an independent economic policy severely constrained by dependency on short-term financing and the need to attract capital by sending the right "signals" to the world financial markets. Both realised the need to act jointly to counter the possibility of a world economic slump.

Mercosur achieved initial success in stimulating inter-regional trade, but in other areas of development it has yet to show results. Whether the deepening of Mercosur becomes reality will depend not only on domestic politics but also on factors, such as the effective leadership of the four Mercosur presidents. Apart from this, there are certain constraints that might have created problem in the success of the Mercosur project. For instance, as long as supranational institutions do not replace the intergovernmental model, Mercosur's survival will depend on the four members' ability to negotiate compromises over their differences while identifying common interests in their negotiations with other regional blocs.

Political Constraints

'The inequality of power explains a good deal of the character and limits of institutionalization' in Mercosur. Brazil is the dominating partner, particularly as Argentina is economically weakened, and Mercosur is a foreign policy tool for strengthening its negotiating position globally. Avoiding dependency continues to be evident in Brazilian preoccupation with national sovereignty and a desire to limit US domination in the region. Brazil is unlikely, therefore, to subordinate its political agenda to the integration process and reluctant to accept community rules and supranational institutions, unless they further its domestic interests. For smaller members on the other hand, and to some extent Argentina, institution-building is essential to their process of development.

Structural Constrains

At the heart of South American governance is 'corporatist' ethos in which the state is the most important determining factor in society, its prime regulator and coordinator: 'the state is always going to have an important role in attenuating social differences'. It has been argued that Brazil's foreign policy, for example, reflects a strong and relatively autonomous state. Such a 'statist' and elite-dominated approach could constrain tendencies to share sovereignty and adopt broader developmental ethos.

Institutional Constraints

Institutions can suffer from politically driven malfunctions. In Mercosur, they are inherently political. Disputes are settled through intergovernmental negotiations emphasizing bargaining, flexibility and adaptability, with no independent judicial body to interpret and apply agreements. While an informal approach may have been valuable in generating interdependence, handling disputes on a case-by-case basis might undermine the formal character of Mercosur. Thus, for long-term development, Mercosur 'needs to be based on clear and authoritative rules and institutional process and a generalised expectation that they will be followed".

Judicial Constraints

The contradictory nature of South American legal systems is mirrored in Mercosur. While its treaties incorporate far-reaching commitments, implementation lacks discipline and rules are flouted. Nor are Mercosur norms community law, but international law requiring national implementation; easier in Argentina (and Paraguay), where international law prevails, than in Brazil (and Uruguay), where this has been resisted. Nor does a codified legal tradition encourage the establishment of precedent and judicial interpretation. An independent, non-political, judicial body might be difficult, therefore, to incorporate.

Mercosur will have to continue to evolve and progress in order to maximise its welfare-enhancing effects. Just like the European Union, Mercosur will have to face up to inevitable economic adjustment in certain sectors. This adjustment will be exacerbated by the fact that the member and associate member countries are not as homogeneous as the EU was during the first leg of its single enterprise. Trade between its largest economies i.e., Brazil and Argentina is still small and at a level below what might qualify it as a 'natural' trading bloc. Further, while average tariffs in Argentina and Brazil have fallen from about 49 per cent to about 13 per cent (not negligible by international standards) and many economy-wide reforms have been taking place, several liberalisation measures are yet to take place, and many specific policies still await agreement. Nevertheless, Mercosur has come a long way so far. It has in some measure expanded trade, lowered consumer prices, rationalised production and promoted competitiveness vis-a-vis the rest of the world.

Because the range of gains from the Mercosur is both uncertain and highly dependent on dynamic effects, the role of industrial policy (IP) becomes crucial. If the major participants are prone to use IP interventions to protect declining industries and if national interests continue to dominate, the road ahead of Mercosur seems to be a narrow one. Policy cooperation, concern for the consistency of policy, smooth sailing within the WTO, and resistance to *ad hoc* responses to deal with economic dislocations are of paramount importance. The reason for this is that so far policy interventions, while not always being optimal, have not been extremely large. Therefore, Mercosur could lose the fruits of its previous efforts or stymie future rewards if it is not diligent with regard to its industrial and trade policies. Keeping this in mind, the following guidelines may be suggestive for Mercosur countries:

- **Transparency of industrial policy initiatives.** The failure to do this has often resulted in overlapping or competing incentives within the country, and a system, which frustrates the comprehensive quantification of the costs and benefits of such policies.
- **Export policies.** A uniform and revenue-neutral export tax can be designed and implemented immediately. The government should also consider eliminating the export reimbursements as soon as possible, which will help raise political support for future reductions of import taxes. In turn, some of the funds now used for export reimbursements should be used to strengthen Argentina's export promotion efforts.
- **Anti-dumping (AD) duties.** One plausible solution for reducing the need for ADs affecting intra-Mercosur trade is to harmonize anti-trust regulations across. Mercosur members need to eliminate the use of intra-Mercosur ADs altogether. If this is not possible, it might be useful to renegotiate regional Safeguards Codes and eliminate the use of ADs as well. WTO-legal safeguards duties are also preferable to the use of ADs against non-Mercosur

imports. The main advantages of safeguard actions over ADs is that they are transitory and the political responsibility for such actions is more clear than under the use of the pseudo-technical criteria leading to ADs.

- **Rapid phase-out of subsidy programmes.** Mercosur countries should set binding timelines for eliminating programmes which lack economic justification. Failure to do so for the EU has resulted in facilitating community-wide subsidisation rather than liberalisation, and in turn exacted a heavy resource cost.
- **Limit admissible types of intervention.** If some form of assistance to industry can be justified on sound economic grounds, governments should work towards adopting uniform policy instruments in order to promote greater transparency and reduce collateral distortions in other markets. Moving towards uniform instruments in this way can serve as a precursor to subsidy phase-out.
- **Elimination of special trading regimes within Mercosur.** It is also time to reform existing extra-Mercosur protectionist arrangements, such as the ones affecting trade in the sugar and autos industries, which are supposed to be addressed by existing Mercosur institutions. It is time to subject these sectors to Mercosur discipline.
- **Elimination of CET exemptions.** With regards to the CET affecting capital good imports, Argentina should look for a Mercosur compromise: in exchange for not delaying CET convergence, it should ask for a significant downward revision of the corresponding tariffs. This is particularly important given the existing empirical evidence that capital goods prices might play a special role in the process of international technology diffusion.

- **Unilateral reduction of the Mercosur CET.** Given Mercosur's past history of unstable and often rising trade barriers, it is understandable that potential partners might be skeptical of the ability or willingness of Mercosur to implement trade reforms. Thus the previously discussed unilateral and Mercosur trade reforms should be implemented in order to enhance the trade bloc's credibility in future FTA negotiations.
- **Consider only functional interventions.** Both theory and practice confirm the positive economic benefits of government assistance to industry in the case of market failure. Functional interventions; i.e. state aid directed at a general objective such as R&D without favouring a particular sector, can be welfare improving. However, government support of specific enterprises is generally recognised as costly for governments and seldom produces returns to justify its expense.
- **Anticipate requests for assistance from declining (sunset) industries.** If Mercosur is to work, resources will have to be reallocated and some industries will have to fold. Assistance programmes to facilitate adjustment should be temporary and conditional upon restructuring efforts such as reducing excess capacity.

There is considerable optimism for the future prospects of Mercosur. Mercosur 2000, the political programme designed to carry Mercosur into the 21st century, as well as discussions for a SAFTA (South American Free Trade Agreement) are underway. The Rose Garden Agreement signed in 1991 (setting up a forum for consultation between the US and Mercosur), and the Inter-Regional Agreement for Economic and Trade Co-operation between Mercosur and the European Union (which was signed by the Head of Governments in

Madrid in December 1995) represent a growing recognition of the importance of the regional market in South America. As Mercosur finds itself involved in more multilateral and bilateral negotiations, such as with EU, NAFTA, ASEAN Free Trade Area, Mercosur is likely to gain momentum. If this is matched by caution in the area of policy, Mercosur's potential can more easily be achieved and can face the challenges of the new Millenium.

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