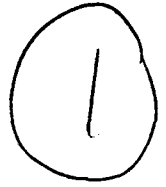


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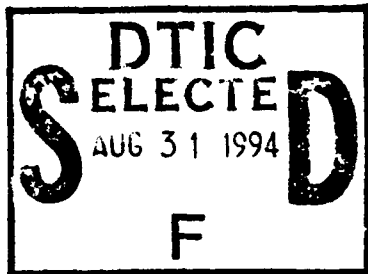
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NAVAL POSTGRADUATE SCHOOL



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THESIS

IMPACTS OF THE MERCOSUR AGREEMENT ON THE
URUGUAYAN ECONOMY

by
Beatriz Legorburu

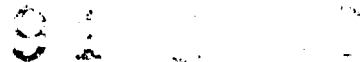
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IMPACTS OF THE MERCOSUR AGREEMENT ON THE URUGUAYAN
ECONOMY

by

Beatriz Legorburu
CPA, *Facultad de Ciencias Económicas y Administración*, 1983

Submitted in partial fulfillment
of the requirements for the degree of

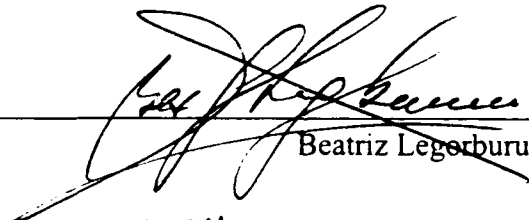
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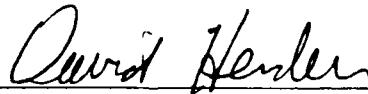
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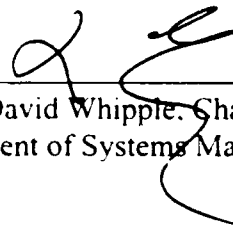
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ABSTRACT

This thesis examines the MERCOSUR agreement (Common Market of the Southern Cone), specifically the provision for a common external tariff and its impact on the economy of Uruguay. The thesis begins by examining the economic regionalism which gives rise to trade agreements such as MERCOSUR and investigates the trade mechanisms through which such regionalism is accomplished. The provisions and background of the MERCOSUR agreement are explored, as well as the economic conditions, current and historical, which exist in the participant countries. The work continues by exploring two possibilities for Uruguay: 1) to continue economic integration by entering a customs union scheduled to take effect on January 1995 or 2) to remain in a free trade zone with the other three countries (Argentina, Brazil and Paraguay). These two possibilities are analyzed using traditional and new theories of international trade. The study further examines foreign direct investment and technology in the context of Uruguayan participation in MERCOSUR or in a free trade zone. The study concludes that if Uruguay, due to its small size, could obtain the special treatment of a free trade zone, the costs of trade diversion would be reduced and Uruguayan welfare would increase.

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I. INTRODUCTION

There is an ongoing global trend toward economic regionalization. Due in part to frustration over slow progress in the General Agreement on Tariffs and Trade (GATT), nations around the world have looked closer to home in trying to form external trade and economic relationships upon which to sustain the growth of their economies. Free trade zones, customs unions, common markets, and economic unions have emerged as the vehicles of choice among nations wishing to pursue regional economic integration. From the limited demands of the free trade zone to the extremely complex requirements of the economic union, the various forms of economic integration offer a wide range of political implications for relations between the governments of participant nations. As the world has moved toward economic regionalization, the nations of Latin America have looked to themselves and their neighbors for market solutions to their economic problems.

As early as 1950, Latin America was investigating the possible benefits of trade agreements, and by 1961 the Latin American Free Trade Association (LAFTA) had come to represent a concrete step toward economic integration. Despite the limited success of this and subsequent agreements, economic cooperation within the region has remained an appealing alternative to Latin American nations. This appeal is based upon the similarity of Latin American cultures and the advantages to be obtained by coalitions of nations with varying levels of resources and development.

The integration process in the area of South America known as the Southern Cone began with bilateral efforts toward economic cooperation between Argentina and Brazil in November, 1985. By 1990, in the Declaration of Buenos Aires, these two countries had committed themselves to a common market by the end of 1994. The Common Market of the Southern Cone (MERCOSUR) subsequently emerged as an alternative that would extend economic integration to the other two countries of the Southern Cone: Paraguay and Uruguay. This four-country agreement was concluded with the Treaty of Asuncion, signed by Argentina, Brazil, Paraguay, and Uruguay on March 26, 1991.

The principal objectives of MERCOSUR include:

- ♦ The free circulation of goods, services, and productive factors
- ♦ Unified customs procedures
- ♦ A common external tariff for trade with the rest of the world
- ♦ Coordinated macroeconomic policies

The agreement has been implemented according to a graduated schedule of tariff reductions; by the end of 1994, tariffs and non-tariff barriers between MERCOSUR participants will have been completely eliminated, creating a free trade zone within the Southern Cone. By January 1, 1995, MERCOSUR is to have established a common external tariff, creating a customs union. This trade bloc of the Southern Cone will comprise four nations that had a combined GNP of \$385.2 billion in 1990.

Among the MERCOSUR participants, the countries that initiated the process, Argentina and Brazil, remain the most developed. The nations of Paraguay and Uruguay

have much smaller economies than their co-participants. In 1990, Uruguay accounted for only 2% of the combined MERCOSUR GNP. In terms of trade, Uruguay was responsible for only 4% of total exports and 5% of total imports during the same year. In view of this drastic difference in the level of Uruguay's economic participation in MERCOSUR, one may anticipate questions regarding the relative benefit available to Uruguay from participating in MERCOSUR.

Among the various considerations regarding Uruguay's participation in MERCOSUR, two factors emerge as contradictory indicators to present a dilemma. Advocates of Uruguay's participation in MERCOSUR point out that most of the country's historical trade has been with the two large MERCOSUR participants, Argentina and Brazil. This line of thinking leads one to conclude that Uruguay would benefit from any preferred trade relationship with those two countries. Adding to the weight of this view is the fact that Argentina and Brazil intend to pursue a common market with or without the other two MERCOSUR participants. If such economic cooperation were to exclude Uruguay, many fear the economic consequences for Uruguay.

On the other side, some argue that Uruguay will achieve the optimum trade situation by establishing the free trade zone at the end of 1994. This view argues that Uruguay is likely to suffer as economic integration continues. The main argument in favor of this point of view is that, because Uruguay currently maintains lower external tariffs than the larger MERCOSUR participants and Uruguay is responsible for a relatively insignificant portion of the total trade of the region, the likely effect of

continued economic integration will be to raise Uruguayan tariffs with the rest of the world. This line of thinking is reinforced by the fear that increasing integration may introduce instability from other countries into the Uruguayan economy.

As seen from these two perspectives, then, the choice seems to be between risking loss of trade with Argentina and Brazil to maintain relationships with other global trade partners on the one hand, or maintaining preferential trade relationships with Argentina and Brazil at the expense of trade with the rest of the world and the risk of introducing economic instability.

The objective of this research effort is to ascertain the effects of the impending MERCOSUR customs union on Uruguay, in light of the economic and trade backgrounds of the participants and the global tendency toward regionalization. In order to illustrate the impact of further MERCOSUR integration, the effect of the common external tariffs will be estimated and compared to the estimated effects from establishing a free trade zone. The comparison will be based on tariff revenue, trade creation, and trade diversion. While exact increases or decreases in the measured indicators are not specified, this research will determine their tendency to increase or decrease. The research will allow general conclusions to be reached about Uruguay's possible benefits and/or disadvantages in continuing the MERCOSUR integration.

Chapter II will provide background information on the global trend toward economic regionalization. Principal areas to be investigated include the facets of economic cooperation at a global level, as well as the transformation of the role of

government in the economy. Additionally, the various vehicles for regional economic integration will be identified and discussed. Two contemporary regional trade agreements, the North American Free Trade Agreement and the European Community, will be discussed in order to provide case illustrations of existing regional trade agreements.

Chapter III presents the objectives of the MERCOSUR agreement. The issues and actions that led to MERCOSUR are discussed in light of other the agreements on Latin American trade which preceded it. Three previous trade agreements are discussed in depth to illustrate three model trends in economic agreements among Latin American nations: the Free Trade Area model, the Common Market model, and the Loose Arrangement model. MERCOSUR is also contrasted to previous trade agreements between the MERCOSUR participants. In addition to the provisions of the treaty, this chapter will discuss important issues that have emerged as the participant countries have moved toward economic integration.

Chapter IV presents a macroeconomic profile of the MERCOSUR participants. Issues to be included in the regional economic analysis include GNP, population, productive capacity, imports and exports, balance of payments, external debt, investments, prices, and the general behavior of the public sector in each country. Economic data for this chapter cover the period from 1970 to 1990.

Chapter V presents the significant results of analysis regarding the impacts of the MERCOSUR integration on Uruguay. The discussion includes the impact of the

agreement's provisions on the country's tariff structure. Additionally, this chapter discusses those impacts from four perspectives, including traditional trade theory, "new" trade theory, openness and economic growth, and foreign direct investment and technology development.

Chapter VI offers conclusions and recommendations based on the research and analysis of previous chapters.

II. REGIONALIZING INTERNATIONAL TRADE

A. ECONOMIC INTEGRATION

1. Economic and Marketing Tendencies at a Global Level

Since World War II, nations all over the world have increasingly integrated economically. Integration creates the most desirable international economic structure by removing artificial barriers to the optimum operation of free trade and by introducing all desirable forms of cooperation and unification.¹ It is possible to consider integration as being both a process and a state of affairs. As a process, it leads to improved allocation of productive resources between the countries that are integrating. It is also the state of affairs at the end of this process -- that is, the optimum allocation of productive resources between countries which have integrated.

At a world level, over the second half of the 1940s and in the 1950s, well defined characteristics can be observed in relation to the economy, trade and politics.

- ♦ Economic power was concentrated in the industrialized countries: United States and Western Europe. These countries shared the same economic interests and had few barriers to trade. The Bretton Woods system, formed at the end of World War II, was envisioned to include the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD) and a multilateral commercial convention.² After approving the IMF and the IBRD, the United States

1. Tinbergen, *International Economic Integration*, Amsterdam, 1954, p. 95.

proposed the Havana Charter, which established the International Trade Organization (ITO). The ITO was intended to produce a multilateral framework for international economic relations. The General Agreement on Tariffs and Trade (GATT) was drawn up in 1947 and originally seen as a temporary institution to fill the gap in international trade until the ITO was approved. It was made permanent after the failure to ratify the Havana Charter.³

- ♦ The socialist countries were a monolithic political bloc and had an economic system practically closed to the rest of the world.
- ♦ The Third World supplied raw materials to the developed countries, and its most modernized industries were property of foreign investments.
- ♦ The United States maintained a convertible currency and allowed essentially nondiscriminatory access to its enormous domestic market.

Throughout the 1960s, important changes were observed. Japan and Germany appeared as economic powers, the socialist countries began to trade with the western nations, and advances were made in Europe's economic integration.⁴

At the beginning of the 1970s, after the effects of the Bretton Woods agreements had been felt, US dominance was questioned; many developing countries demonstrated that they were no longer content to supply raw materials and import manufactured goods.

² Root, Franklin R., "The Bretton Woods International Monetary System and its Collapse" in *International Trade and Investment*, International Thompson Publishing, Seventh Edition, 1993.

³ Root, Franklin R., "Multilateral Trade Agreements Under GATT" in *International Trade and Investment*, International Thompson Publishing, Seventh Edition, 1993.

⁴ Schnitzer, Martin C., *Comparative Economic Systems*, South-Western Publishing Co., 1991.

This was to be a decade of world inflation, scarcity of oil, and excessive increases in the debts of developing countries.⁵

The 1980s were good to the developed countries that had reformed their economies; but it was a time of recession for third world nations which had not transformed their economies. In Latin American countries, the recession was caused by a complex set of internal and external factors.⁶ Internally, inadequacies and excesses in national economic policies led to a sudden decline in economic activity. There was an increase in unemployment and a drop in real wages, while prices continued climbing at ever-faster rates. For example, unemployment in Argentina increased from an average annual rate of 3.3% in the 1970s to 6.1% in the 1980s; in Uruguay, from 7.4% to 15.5%, respectively. The growth of the Consumer Price Index in Argentina rose from an annual rate of 150.4 in 1977 to 688.0 in 1984; in Uruguay, from 46.0 to 83.0 in the same period.⁷

During the 1970's, the Latin American countries absorbed ever-increasing amounts of foreign resources. This led to an extraordinary increase in external debt and rapid escalation of deficits. Externally, three decisive factors combined to aggravate the situation. First, there was a deterioration in terms for trade. The response of the industrialized countries to the oil price increase was oriented toward reducing imports with a consequent drop in the volume of international trade. For Latin America over the

⁵ Krugman, Paul R. and Obstfeld, Maurice, "Developing Countries and the International Debt Problem" in *International Economics: Theory and Policy*, Harper Collins Publishers, Second Edition, 1991.

⁶ Iglesias, Enrique V. , *Reflections on Economic Development: Toward a New Latin American Consensus*, Inter-American Development Bank, Washington, DC, 1992 and United Nations, *Economic Survey Of Latin America And The Caribbean*, 1985.

⁷ United Nations, *Economic Survey of Latin America and The Caribbean*, Volume II, United Nations, 1990.

period 1977-1983, the terms of trade with the non-oil-exporting countries deteriorated 38%.⁸ Second, there was a spectacular rise in the real level of interest rates, which increased from an average of 1.4% before 1980 to 7.1% in the period 1980-1985. For this reason, Latin America's annual interest payments climbed from \$6.9 billion in 1977 to over \$39 billion in 1982.⁹ Third, there was a sudden drop in net capital inflows. In 1982 and 1983 loan grants were suspended to Latin American countries. After the region had obtained nearly \$38 billion in loans in 1981, the flow of foreign resources dropped back to 1970 levels, namely \$5 billion by 1983.¹⁰ Though economic crisis was precipitated by such external factors, the length and depth of crisis in each country was primarily determined by that country's subsequent economic policies.¹¹

Over the last thirty years, the most important economic tendency at a world level has been globalization. The term "globalization" refers generally to a marketplace for standardized products that is worldwide in nature.¹² It relies on economies of scale in production, distribution, marketing, and management. It also has important implications for the volume and pattern of world trade.

⁸ Iglesias, Enrique V. , *Reflections on Economic Development: Toward a New Latin American Consensus*. Inter-American Development Bank, Washington, DC, 1992 and United Nations, *Economic Survey Of Latin America And The Caribbean*, 1985.

⁹ United Nations, *Economic Survey of Latin America and The Caribbean*, Volume II, United Nations, 1990.

¹⁰ *Ibid.*

¹¹ Iglesias, Enrique V. , *Reflections on Economic Development: Toward a New Latin American Consensus*, Inter-American Development Bank, Washington, DC, 1992 and United Nations, *Economic Survey Of Latin America And The Caribbean*, 1985.

¹² The term globalization was originally defined by Professor Theodore Levitt of the Harvard Business School. See Belous, Richard S., and Hartley, Rebecca S., *the Growth of Regional Trading Blocs in the Global Economy*, National Planning Association, 1990.

the government has only to regulate macroeconomic policies and facilitate the private market.

In the developed countries, government intervention was intended to satisfy social demands, and to correct market failures. In some countries this intervention seems to have been successful. Some authors cite Japan as an example, but there are several sources of Japan's economic growth, and its government plays a smaller role than those in some other developed countries.¹⁵ In others, like England, intervention has been blamed for the economy's virtual destruction.¹⁶

In the developing countries, intervention was pervasive. The government played a significant role in economic industrialization and development. In this case, not only was there government planning and control of the economy, but these countries created protectionist policies and a big government sector.¹⁷

The interventionist position has faced serious problems since the 1970s, however. Developed countries faced recession, inflation, unemployment, and the necessity of adjusting their economies. On the other hand, developing countries, especially those in Latin America, have suffered economic deterioration, recession, inflation, unemployment, and large debts, all blamed on government intervention.¹⁸

¹⁵ Henderson, David R., "Japan and the Myth of MITI," in *The Fortune Encyclopedia of Economics*, Warner Books, Inc., 1993.

¹⁶ International Monetary Fund, *Issues and Developments in International Trade Policy*, [Several issues].

World Bank, *World Development Report*, Oxford University Press, [Several issues].

¹⁷ World Bank, *Global Economic Prospects and the Developing Countries*, Washington D.C., 1992.

¹⁸ Iglesias, Enrique V. , *Reflections on Economic Development: Toward a New Latin American Consensus*, Inter-American Development Bank, Washington, DC, 1992.

The globalization of production and marketing was accompanied by other tendencies at the world level, such as the relative expansion of the service sector, the increased importance of advanced technology and specialized labor, the decreased importance of raw materials and unskilled labor costs, and the increased importance of created comparative advantages (education, infrastructure, technology, etc.) in relation to natural comparative advantages (availability of raw materials and geographic location).¹³

2. The Transformation of the Role of the Government in the Economy

The transformation of the world economic structure was accompanied by changes in the government's role. The debate about the government's role has been based on two positions.¹⁴ On one hand, interventionists maintain that the market system alone is not efficient; it is necessary for the government to intervene to plan, coordinate and control the economic system and overcome the inefficiencies of the free market. This position argues that the government, using its authority, has to intervene directly in the free function of the market in order to obtain determinate objectives; it is based on the perception that important developments in Europe and Asia over the last forty years have been obtained with government intervention.

On the other hand, the orthodox position argues that the government has to engage in more moderate, but still significant, intervention. This position recognizes that

¹³ International Monetary Fund, *Issues and Developments in International Trade Policy*, [Several issues].

World Bank, *World Development Report*, Oxford University Press, [Several issues].

¹⁴ Sanderson, Steven E., *The Politics of Trade in Latin American Development*, Stanford University Press, 1992.

Spero, S.E., *The Politics of International Economic Relations*, St. Martins Press, 1985.

The current trend at the international level is based on reforms to modify government intervention and abandon central planning in favor of an economy based on free market principles. Developed countries are attempting to stimulate economic development through free market principles and by establishing measures to increase the profitability of enterprises. In the case of developing countries, the principal reforms in the role of the government are related to free trade and the privatization of public enterprises.¹⁹ The World Bank and the International Monetary Fund are promoting liberal policies which will change the character of government intervention in the developing countries.

The new trends in the role of the government, together with the transformations in the global economic structure, are being accompanied with new characteristics in the structure of international trade.

B. REGIONAL ECONOMIC INTEGRATION

1. Regional Trade arrangements

A striking feature of the 1980s was the renewed interest in regional integration. Formal and informal agreements among groups of countries are not a new phenomenon, however. Historically, the best known is the Zollverein, formed in 1834 under Prussia's leadership, which paved the way for Germany's political unification.

¹⁹ International Monetary Fund, *Issues and Developments in International Trade Policy*, [Several issues].

World Bank, *World Development Report*, Oxford University Press, [Several issues].

Many view the increasing tendency toward regional trade arrangements as a cause for concern; others view it as a natural consequence of the regional integration that has already taken place, both formally and informally. These developments raise the question of whether regional trade arrangements are likely to hinder or support an open, multilateral trade system.²⁰

The term "globalism" is often used in reference to the Global Agreement on Tariffs and Trade (GATT) and its guiding philosophies. Although the GATT has well over 100 contracting parties and associated countries, it still does not include a significant number of nations with centrally planned economies.²¹ It also does not regulate many areas of trade undertaken by the contracting parties. Thus, the GATT is a multilateral rather than a global trading system, even though its members and associates conduct over four-fifths of total world trade. Multilateralism describes an open trading system that includes many nations. The GATT has been weakened through the often strong support for protectionism in specific sectors, and by the perception that managed trade may be superior to market openness in some cases. Although an improved GATT system might be the first choice of many in the international trading community, many business, labor, and political leaders have lost faith in the GATT. They are turning to regional trading blocs as realistic "second-best" policy options. Regionalism generally refers to the construction of free trade areas, customs unions or agreements relating to specific sectors.

²⁰ International Monetary Fund, *Issues and Developments in International Trade Policy*, Washington DC, 1992.

²¹ Belous, Richard S., and Hartley, Rebecca S., *The Growth of Regional Trading Blocs in the Global Economy*, National Planning Association, 1990.

Regional agreements are supported because:

- ♦ They provide some of the benefits of multilateral liberalization with more predictable and controllable adjustment costs
- ♦ They bring together smaller groups of countries with less diversity than is present in the GATT membership

This either circumvents or reduces the harmonization problems associated with non-tariff barriers.

Important differences exist between the principles and characteristics of the GATT and regional trading blocs. The multilateral GATT system is based on the principle of nondiscrimination. In theory, a GATT member is bound to grant equal treatment to all other GATT members in applying and administering tariffs and other regulations. This is the most-favored-nation (MFN) clause of the GATT. No country may give special trading advantage to another member within the "ideal" GATT framework. However, regional trading blocs are founded on the principle of preferences. Hence, regional trading bloc members practice discrimination.

A second basic GATT principle is that protection for domestic industries should be provided only through tariffs, to the maximum extent possible. This principle is designed to make protectionism clear or transparent. However, in regional trading blocs, quantitative restrictions or quotas have been used. Thus, supporters of regional trading blocs view managed trade as a realistic alternative for solving difficult international trade problems.²²

²² Bhagwati, Jagdish N., *The World Trading System at Risk*, Princeton University Press, 1991.

GATT supporters tend to base their economic view of the world on the efficacy of free trade and the concept of comparative advantage. Regional trading bloc supporters, although not against free trade, frequently see a more activist role for the government. They tend to base their economic world view on concepts such as strategic trade, rather than on the traditional concept of free trade.²³ Strategic trade maintains that trade policies, investment strategies, government activities, and so forth can create or alter a nation's comparative advantage in the global economy.

The GATT has dealt with this real world by establishing "escape clause" regulations that tolerate regional trading blocs in certain cases. Under Article XXIV of the GATT, a regional bloc may be considered consistent with the GATT if the bloc meets a three-part test. First, the bloc or free trade area must include a substantial amount of all the merchandise traded between nations inside the bloc or area. Second, the nations that form the bloc must go through a notification process with an administrative group established in the GATT. Third, the bloc must not be formed to raise new trade barriers to nations outside the bloc. In the real world, then, the GATT has coexisted with many regional trading blocs.²⁴

Whether regional trade arrangements hinder or support the multilateral trade system will depend on how closely they conform to Article XXIV and whether remaining trade barriers to exports from nonmember countries can be kept low. To minimize the adverse effects on third countries, it has been suggested that members of regional trade

pp. 23-47.

²³ Marc Levinson, "Is Strategic Trade Fair Trade?" *Across the Board* (June 1988) pp. 47-51

²⁴ *Ibid.*

arrangements go beyond the requirements of Article XXIV by reducing their trade barriers.

If multilateral liberalization is the ultimate goal, four questions should be asked about evolving and proposed agreements.

- Does the agreement raise barriers to nonmember countries?
- Does the agreement foster stronger economies that are better able to accept adjustment in the future and better able to participate in broader multilateral liberalization?
- Does the agreement address non-tariff issues in a manner consistent with progress under the GATT?
- Do concessions that member countries make to each other preclude broader liberalization under the GATT?

2. Agreements of Economic Regionalization

It is possible to distinguish five stages of economic regionalization, considering the arrangements that the participant countries make for economic integration and how unified their policies are against other countries.²⁵

- Industrial free trade area: the participant countries agree to reduce their mutual import tariffs and quantitative restrictions on industrial products

²⁵ Root, Franklin R., "The Theory and Policy of Economic Integration: The European Community and Nafta", *International Trade and Investment*, University of Pennsylvania, 1993.

- Full free trade area: the participant countries agree to eliminate mutual import tariffs and quantitative restrictions on all goods and services (except capital services)
- Customs Union: the participant countries agree 1) to eliminate mutual import tariffs and quantitative restrictions on goods and services (except capital services); and 2) to establish identical tariffs for the imports from third countries (except capital services)
- Common Market: the participant countries agree 1) to eliminate mutual import tariffs and quantitative restrictions on goods and services (except capital services); 2) to establish identical tariffs on the imports from third countries; and 3) to permit the free mobility of productive factors
- Economic Union: the participant countries agree 1) to eliminate mutual import tariffs and quantitative restrictions on goods and services; 2) to establish identical tariffs on the imports from third countries; 3) to permit the free mobility of productive factors; and 4) to unify their fiscal, monetary and socioeconomic policies

Each mechanism achieves successively greater economic integration. Conceptually and historically, agreements of a certain level have tended to evolve into agreements with a higher level of integration.²⁶

It is important to emphasize that there is a large variety of concrete agreements in each category. In addition, each country signs an agreement considering a certain

²⁶ Ibid.

strategy to reinforce its economy. To evaluate an agreement's desirability, the specific content and the strategy that create it must be considered.

Each of these levels of integration has important political implications for the way that each government must cooperate with the other participants. For example, a free trade agreement limits the power of participant countries' governments to establish barriers to trade. It also harmonizes customs management and establishes mechanisms to resolve controversies. To achieve free trade, a country has to adjust its monetary and fiscal policy, although these adjustments are not imposed in the agreement. In the case of a common market, each country transfers specific powers to joint organizations. These organizations are superior to the governments of the participant countries in certain areas: they must first be accepted by the governments to function effectively.

C. CONTEMPORARY EXAMPLES OF ECONOMIC INTEGRATION

1. The European Community

European economic integration began in the 1950s and is still ongoing. Extending the common market from coal and steel to the rest of the economy did not come without some setbacks in the movement towards European integration.

In March 1957, the Treaty of Rome was signed, establishing the European Economic Community. It went into effect on January 1, 1958. There were several important achievements of the first stage of the economic integration process: eliminating mutual tariffs and the establishing an external common tariff for imports from

third countries in 1959; applying a common agricultural policy in 1962, and advancing toward coordinating economic policies, especially monetary policy, in 1979.

The principal obstacles to constructing an effective common market were political. The countries had difficulty agreeing on the political meaning and the institutional orientation of integration, giving rise to long periods of debate, such as that over the European Parliament. The EC was unable to coordinate a common policy to face the recession and high unemployment in the 1970s. The governments of the member countries protected their domestic economies. Protectionism probably hindered economic recovery and slowed the development of the EC. Because national solutions had not been effective, the countries decided to favor economic integration -- especially monetary integration.

In 1979, the European Monetary System took effect. The objective was to create a zone of monetary stability and achieve independence from the US dollar. This system was based primarily on coordinating the countries' economic and monetary policies. This system was an important antecedent, perhaps the principal one, to accelerating the economic integration process in the 1980s.

The Single European Act, signed in 1986, modified the Treaty of Rome. It ratified the compromise of achieving a single European market. Additional measures strengthened the European monetary system, sought to eliminate differences in development among the EC countries, established a common scientific and technological development policy to strengthen European industry, and protected and improved the way

natural resources were used. The document also initiated some institutional modifications.

Since then, the EC has made progress: economic development has been accelerated, and internal demand, employment, and investment have increased. However, these benefits have not been distributed equally among all the member countries, because the deregulation processes yield different results in the different countries.

The EC recognizes the role of international trade. European integration has the objective of promoting a free-trade system that supports the multilateral mechanisms. In spite of this, the European Community's trade partners have been greatly concerned; they have begun to implement measures to participate in the European market. For example, foreign investment and mergers and acquisitions of industrial enterprises have increased in the EC.

The EC experience illustrates at least two points: economic interests can overcome political conflicts that are an obstacle to integration, and integration is a long process involving many steps.

2. The North American Free Trade Agreement

In April 1991, the governments of the United States, Canada, and Mexico launched tripartite negotiation for a North American Free Trade Area (NAFTA). The resulting treaty went into effect in January 1994. This agreement is based on the Canadian-United States Free Trade Agreement of January 1989, and added two annexes related to labor concerns and environmental issues. Among other things, the agreement

illustrates the present strategy of developed countries: participating in trading blocs of geographically co-located countries to maintain and increase their commercial competitiveness in the world economy. In consequence, this bilateralism constitutes a challenge to the international trade system, i.e., GATT.

In evaluating the agreement between Canada and the United States, J.J. Schott²⁷ points out that the agreement has several objectives:

- ♦ To liberalize trade
- ♦ To improve bilateral investments
- ♦ To solve bilateral problems related to trade in the automotive sector
- ♦ To solve problems that emerge in disputes about subsidies and compensated tariffs
- ♦ To create new rules to regulate services trade and liberalize the financial services market
- ♦ To create a better framework for bilateral investment and trade relations
- ♦ To promote the multilateral cooperation in the GATT discussions about trade and investment

The Preamble to NAFTA sets out the principles and aspirations on which the agreement is based. The three countries commit to promoting employment and economic growth in each country by expanding trade and investment opportunities in the free trade area and by enhancing the competitiveness of Canadian, Mexican and US firms in global markets. The NAFTA partners also resolved to promote sustained development, to

²⁷ J.J. Schott, *United States-Canada Free Trade: An Evaluation of the Agreement*. Washington: Institute for International Economics, 1988.

protect the environment, to protect, enhance, and enforce workers' rights, and to improve working conditions in each country. NAFTA also incorporates the fundamental national treatment obligation of the GATT. Once goods have been imported into one NAFTA country from another NAFTA country, they must not be the object of discrimination. This commitment extends to provincial and state measures.

The most important part of the agreement is the provision for eliminating tariffs. NAFTA progressively eliminates tariffs on goods qualifying as "North American" under its rules of origin. For most goods, existing customs duties will either be eliminated immediately or phased out in five or ten equal annual stages. For certain sensitive items, tariffs will be phased out over a period of up to 15 years. Tariffs will be phased out from the applied rates in effect on July 1, 1991, including the United States Generalized System of Preferences (GSP) and the Canadian General Preferential Tariff (GPT) rates. Tariff phase-outs under the Canada-United States Free Trade Agreement will continue as scheduled under that agreement. NAFTA provides that the three countries may consult and agree on a more rapid phase-out of tariffs. All three countries will eliminate prohibitions and quantitative restrictions applied at the border, such as quotas and import licenses over a period of up to 15 years. However, each NAFTA country maintains the right to impose border restrictions in limited circumstances (e.g., to protect human, animal, or plant life or health). Special rules apply to trade in agriculture, automobiles, energy, and textiles. NAFTA establishes rules on the use of "drawback" or similar

programs that provide refunds or waive customs duties on materials used in producing goods subsequently exported to another NAFTA country.

Among NAFTA's specific topics, those related to financial services, agriculture, and energy are of particular interest. Concerning financial services, NAFTA establishes a comprehensive approach to disciplining government regulatory measures. The corresponding section covers measures affecting financial services provided by institutions in the banking, insurance and securities sectors, as well as other financial services. The section also sets out certain country-specific liberalization commitments, transition periods for compliance with the agreed principles, and certain reservations listed by each country. Under the agreement, financial service providers of a NAFTA country may establish banking, insurance and securities operations, as well as other types of financial services in any other NAFTA country. Each country must permit its residents to purchase financial services in the territory of another NAFTA country. In addition, a country may not impose new restrictions on the cross-border provision of financial services in any sector, unless the country has exempted that sector from this obligation.

In relation to agriculture, the NAFTA sets out separate bilateral agreements on cross-border trade in agricultural products, one between Canada and Mexico, and the other between Mexico and the United States. Both include a special transitional safeguard mechanism. As a general matter, the rules of the Canada-United States Free Trade Agreement on tariff and non-tariff barriers will continue to apply to agricultural

trade between Canada and the United States. Trilateral provisions in NAFTA address domestic support for agricultural goods and agricultural export subsidies. Mexico and the United States will immediately eliminate all non-tariff barriers to their agricultural trade, generally through their conversion to either "tariff-rate quotas" or ordinary tariffs.

In relation to energy and basic petrochemicals, the corresponding section sets out the rights and obligations of the three countries regarding crude oil, gas, refined products, basic petrochemicals, coal, electricity and nuclear energy. NAFTA's energy provisions incorporate and build on GATT disciplines regarding quantitative restrictions on energy and basic petrochemical imports and exports. NAFTA prohibits a country from imposing minimum or maximum import or export price requirements, subject to the same exceptions that apply to quantitative restrictions. NAFTA also allows each country to administer export and import licensing systems, provided they are consistent with the agreement's provisions. In addition, no country may impose a tax, duty or charge on energy or basic petrochemical imports unless the same tax, duty or charge is applied to such goods when consumed domestically. Import and export restrictions on energy trade will be limited to circumstances involving specific issues dealing with a short supply situation, such as conservation of exhaustible natural resources, or implementing a price stabilization plan. For example, if so much Mexican oil is sold in the American market that the Mexican government perceives a threat to its continued existence as a Mexican national resource, the Mexican government might impose an export tax or restriction on

oil in accordance with this provision of the treaty. The agreement does not eliminate the possibility of foreign investment in the oil industry.

Other important points of the agreement are:

- ♦ NAFTA will eliminate barriers to trade in North American automobiles, trucks, buses and automotive parts ("automotive goods") within the free trade area, and eliminate investment restrictions in this sector, over a ten-year transition period.
- ♦ Each country will treat NAFTA investors and their investments no less favorably than its own investors. With respect to measures of a state, provincial or local government, national treatment is defined to mean treatment no less favorable than the most favorable treatment accorded to investors of the country of which it forms a part. In addition, each country must provide the investments of NAFTA investors treatment in accordance with international law, including fair and equitable treatment and full protection and security. No NAFTA country may directly or indirectly expropriate investments of NAFTA investors except for a public purpose, on a non-discriminatory basis and in accordance with due process of law. Compensation to the investor must be paid without delay at the fair market value of the expropriated investment, plus any applicable interest.
- ♦ It is important to point out that while the Canada-United States Free Trade Agreement did not protect intellectual property, NAFTA establishes a high level of obligations respecting intellectual property. Each country is to adequately and

effectively protect intellectual property rights and effectively enforce these rights against infringement, both internally and at the border.

- ♦ NAFTA does not create a common labor market. Each NAFTA country maintains its rights to protect the permanent employment base of its domestic labor force, to implement its immigration policies and to protect the security of its border.
- ♦ NAFTA acknowledges each country's right to protect its identity and culture.
- ♦ NAFTA establishes institutions to implement the agreement: the Trade Commission and the Secretariat.
- ♦ NAFTA commits the three NAFTA countries to implementing the agreement in a manner consistent with environmental protection and to promoting sustainable development.

Looking at the two agreements, it is apparent that the NAFTA is completely different from the European Community. It is only a free trade zone and doesn't involve disruptive issues such as those encountered in implementing a common market or an economic union (i.e., a common external tariff, the freely moving productive factors, and coordinated macroeconomic policies).

III. THE MERCOSUR AGREEMENT

A. BACKGROUND

1. Historical Latin American Trade Agreements

The first steps toward Latin American integration were taken in the 1950's, but no concrete framework was established until 1960. Since then, three different types of integration systems have been implemented with different degrees of success. The first, was the Latin American Free Trade Association (LAFTA).²⁸ It attempted to gradually eliminate barriers to intra-regional trade. However, it did not establish a common external tariff or provide for any substantial measure of domestic or external policy coordination. The second agreement created subregional common markets, like the Andean Group²⁹ and the Central American Common Market (CACM).³⁰ These common markets were true customs unions with a much larger degree of policy homogeneity. The third model is represented by the Latin American Integration Association (LAIA).³¹ It provides a framework for negotiating multilateral trade agreements based on initial bilateral agreements.

²⁸ Asociación Latinoamericana de Libre Comercio (ALAC). The Montevideo Treaty was signed by Argentina, Brazil, Chile, Mexico, Paraguay, Peru, and Uruguay. In 1961, Ecuador and Colombia added their signature. Venezuela joined LAFTA in 1966 and Bolivia in 1967.

²⁹ Grupo Andino. The original signatories of the agreement were Bolivia, Chile, Colombia, Ecuador, and Peru. In 1973, Venezuela joined the agreement and in 1976 Chile decided to leave.

³⁰ Mercado Común Centroamericano. The signatories are: El Salvador, Guatemala, Costa Rica, and Nicaragua. Honduras withdrew in 1971.

³¹ Asociación Latinoamericana de Integración (ALADI), including Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela.

a. *The Free Trade Area Model (LAFTA)*

In the late 1950s, many of the Latin America economic and political leaders concluded that their countries' deteriorating trade situations, which had been a major problem during the decade, were a very long-run phenomenon of the world economy. Concurrently, the larger countries in the area began to realize that the import-substitution industrialization strategy followed in the post-war period was constrained by severe domestic-market limitations, among other factors. The magnitude of the investments needed to carry import substitution beyond the stage of consumer commodities to intermediate and capital goods,³² and serious doubts about the profitability of those investments given the restricted size of the potential market, convinced them to abandon the inward-looking industrialization approach. At the same time, the gains they had achieved in industrial productivity, although important in many cases, were far less impressive than expected. Therefore, their competitiveness in foreign markets remained low; this was hampering the transition from import-substitution to an export-led development strategy.

In these circumstances, regional economic integration appeared to be the most promising alternative; it would eliminate both the domestic market limitations and the need to penetrate the markets of the industrialized countries, an extremely difficult task. Even though the optimality of integration supported this course of action, economic integration was basically regarded as a means of import substitution. Opening a larger

³² The high cost of further import substitution is due to such factors as indivisibility in plant size.

market, which would remain highly protected from the rest of the world, would enable the import-substitution process to be deepened at the regional rather than the national level. Nevertheless, it was already possible to discern the seeds of the problems that later plagued the first formal attempt at integration. Various members were at different points in the process of import substitution. This was bound to result in a very unequal distribution of benefits.

The widespread acceptance of economic integration to advance economic development led to the 1960 Montevideo Treaty. This treaty established the Latin American Free Trade Association (LAFTA). While that treaty provided for eventually creating a Latin American Common Market, it initially envisaged only negotiating multilateral regional tariff reductions and eliminating other barriers limiting the volume of intra-area trade. It contained no provisions for coordinating external commercial policy, and no practical rules for harmonizing the internal policies of the member countries.

LAFTA established a 12-year transition period during which the member countries were to gradually eliminate most of their mutual trade barriers through product-by-product negotiations. Two tenets were to serve as guidelines for implementing the agreement: the principle of reciprocity and the "most favored nation" clause. Reciprocity was designed to allow those members whose trade flows with the rest of the area did not increase, or became largely unbalanced, to request compensation. The "most favored nation" clause was similar to the GATT principle; each member country

should extend to all the other members any tariff advantage granted to third countries (whether or not the third country is a party to the agreement). However, in accordance with the principle of reciprocity, member countries could grant some members tariff reductions not extended to the rest, provided that the beneficiary was a country with a relatively lower level of economic development. Which of the participants were the "relatively less developed" countries was never clearly established.³³

The agreement was to be implemented through three negotiation mechanisms: the National Lists, the Common Lists, and the Agreements for Industrial Complementation. The National Lists contained those products for which an individual member country agreed to reduce its tariff level by at least 8 per cent after each round of negotiations. The Common Lists were to be negotiated every three years in a multilateral forum and were to include those commodities for which all the members, collectively, agreed to eliminate all internal trade restrictions over a formative 12-year period. The Agreements for Industrial Complementation were conceived as bilateral understandings between regional members to coordinate their industrial policies. The objective was to promote the production of commodities not yet subject to intra-regional trade. These agreements were to be mainly bilateral, but any member could join through negotiations.

LAFTA seemed to embody the promise of steady progress toward eliminating trade barriers in the region. This promise, however, was never fulfilled. Not even the short-term goal of establishing a free trade area by eliminating the tariffs on the

³³ In practice, however, Bolivia, Ecuador, Paraguay, and Uruguay were considered to belong to that group.

Common List was achieved. The National Lists were of little practical importance and their enactment all but stopped when the Andean Group was created in 1969. Only one common list was approved, in 1964, but never became effective. After 1969, the focus of negotiations in LAFTA shifted from trade issues to the Agreements for Industrial Complementation. However, these agreements covered very few sectors. They were generally dominated by multinational corporations, mostly located in the three larger countries, Argentina, Brazil, and Mexico.

The standstill reached by LAFTA in 1969, and its decline thereafter, are clearly reflected by the share of negotiated commodity trade in total intra-regional trade. This percentage, which reached a peak of 88.7% in 1964-66, fell to 40% by the end of the 1970s.³⁴ Intra-regional imports not subject to LAFTA agreements grew faster than those on which some type of tariff reduction had been successfully negotiated. An even more striking fact is that imports subject to LAFTA agreements were no more than 6 percent of the total imports to the region from the rest of the world in 1979.

What are the main underlying reasons for LAFTA's weakness? LAFTA's vulnerability arises from the very nature of the legal document from which it was born. As its name indicates, LAFTA was designed as a framework for reducing the limitations to regional trade. The original treaty reflected this "pure trade approach" to integration. It did not provide for any mechanism that would evenly distribute the costs and benefits from the potential increase in trade flows, nor instruments for planning multilateral

³⁴ Trade is measured by imports. The numerical information is from Kesman, Carlos V., *ALALC-ALADI: Transformación y Situación Actual*, Novedades Económicas de Fundación Mediterránea, 5, Octubre 1983.

investments in industries with a regional rather than national scope. It also did not harmonize domestic monetary, fiscal, and exchange-rate policies. The smaller countries in LAFTA were interested in advancing beyond the pure "trade approach" and sponsored instruments that would use the integration process as a framework for implementing collective development initiatives. Thus, in 1964, a resolution was approved establishing formal mechanisms for programming regional investments. However, this decision was never implemented. Since opportunities for substantially expanding extra-regional exports were not perceived, no attempts were made to collectively exploit possible externalities in promoting exports (i.e., developing common marketing strategies or exploiting common lines of credit). Moreover, in the absence of any common policy for treating foreign investment, LAFTA offered large profit opportunities in a number of specific areas for foreign-owned firms. These firms could take advantage of the larger market size by locating their operations in countries with a more favorable treatment. This situation created distortions since industries relocated from one member country to another, not for underlying economic factors, but because of the different financial treatment of foreign investment.

b. The Common Market Model (the Andean Group)

The limitations and internal contradictions in LAFTA completely paralyzed the process, and convinced many members that a different model was required if integration was going to play a pivotal role in achieving sustained development through trade. For that reason, the Andean countries, which felt a stronger need to expand their

markets than the larger countries in the region, decided to follow a different, much more ambitious, pattern of integration. In 1969 they signed the Cartagena Agreement, which formally created the Andean Group. There was a marked desire among the members to learn from the LAFTA experience and to correct that framework's shortcomings. The main operating principals established by the Andean Group were the following:

- ♦ Mutual trade liberalization within the subregion would be carefully planned at a global level
- ♦ A common external tariff with the rest of the world would be gradually established
- ♦ Costs and benefits would be distributed mainly by implementing regional investment programs
- ♦ Efforts would be made to harmonize domestic economic policies, starting with the treatment of foreign investment
- ♦ Special treatment would be given to the two relatively less developed countries in the area, Bolivia and Ecuador, which would be allowed to implement the agreements at a slower pace

These five principles were expected to solve the serious problems that were presented by LAFTA. In addition, the Andean Group's prospects were more promising in that its members had fewer structural dissimilarities and fewer conflicts of interest. Moreover, frictions would be minimized through more global and automatic negotiations instead of item-by-item negotiations, as in LAFTA. The project envisaged a specific horizon for adopting a common external tariff and immediately began planning

subregional industrial development. However, these two tasks proved to be much more difficult than originally thought and, to some extent, became important stumbling blocks in advancing the Andean Group. In addition, some problems were not addressed in a comprehensive manner and remained, as in LAFTA, obstacles to sustained progress. There was no proper mechanism to align the individual countries' exchange-rate policies with the subregional liberalization policies or to coordinate their export promotion strategies. In addition, intra-regional factor mobility was almost totally disregarded in the Cartagena Agreement.

c. A Loose Arrangement Model (LAIA)

With the stagnation of LAFTA and the more comprehensive arrangements reached within the Andean Group, the rest of Latin America felt that the formal framework for integration should be reshaped. Against this background, the Latin American Integration Association (LAIA), was created in 1980 to replace LAFTA. Although it had high aspirations for the long run, the new organization was in fact a loose framework with a smaller scope than LAFTA. The two basic instruments of LAIA are negotiated partial agreements and regional tariff preferences. The partial agreements cover bilateral tariff reduction and contain a "convergence" clause that allows other members to negotiate their inclusion in the agreements. The regional tariff preferences are limited reductions in each member's external tariff. They apply to all the members of the Association. These preferences do not constitute a common lower tariff for all the member countries, since each country maintains the level of its tariff with third countries

but grants a specific preference to the other countries of the region. Members therefore have preferential access, relative to the rest of the world, to the markets of other members, but intra-regional tariffs continue to differ for the same commodities.

Thus, LAIA replaced the global program of regional liberalization which characterized LAFTA by a formal arrangement aimed at setting up an area of partial economic preferences. Although this shift implies a weaker commitment by the non-Andean countries to economic integration, it also reflects a more realistic and pragmatic attitude. In LAIA, trade negotiations are bilateral; LAIA also abandons the most-favored-nation clause, which was LAFTA's centerpiece. This makes generalizing preferences a non-binding, negotiated process. It therefore facilitates agreements between countries with common interests that may not be shared by the rest of the member countries. This approach may increase intra-regional trade flows and thus create an environment that is more conducive to regional cooperation in other areas. In addition, bilateral agreements may be concluded by countries that already have trade relations.

The regional tariff preferences may be a source of contention. If a unified tariff for intra-association trade is not adopted, the access each country grants to the other members may vary sharply. If, for example, the tariff of country A is unnecessarily high while the tariff of country B is very low, it may essentially preclude regional access to A's market, while entry into B's market may be free for member countries. This difference is bound to create friction, and will limit the number of agreed tariff preferences. In addition to preferential margins, LAIA requests all members to eliminate non-tariff

restrictions on intra-regional trade. This request has only been fulfilled to a very limited extent.

2. Previous Agreements between Uruguay and other MERCOSUR

Participants

In the last 15 years, trade between Uruguay and both Argentina and Brazil underwent many important changes. In particular, Uruguay's exports expanded and diversified. These changes were associated with the decision to sign bilateral trade agreements with the neighboring countries and to initiate policies to stimulate traditional exports.

Uruguay's place in the international community has also experienced important changes since 1970. Today Uruguay has a relatively open economy that depends in an increasing way on exports to create revenues, to finance input imports, and to cancel the obligations resulting from international deals. The nature and magnitude of Uruguay's relationship with the rest of the world has changed. In 1970, 75% of exports were traditional exports;³⁵ in 1989, only 37% were those products. In addition, Uruguay diversified its use of natural resources and increased its exports of products made with imported raw material, as in the chemical industry.

The second point concerns the importance that Argentina and Brazil have in Uruguay's external sector. Uruguay's economy was closely linked to those of its neighbors through two bilateral agreements: the Argentine-Uruguayan Convention for Economic Complementarity signed on August 14, 1974,³⁶ and the Increased Trade

³⁵ Beef, leather, and wool.

Protocol with Brazil, signed on June 12, 1975.¹⁷ Both agreements included reciprocal duty-free access for some products to the neighbor's market.

The CAUCE increased Uruguayan exports to Argentina. The agreement covered 65.2% of Uruguay's total exports to Argentina over the period 1982-1984. Likewise, it covered the 3% of Uruguay's imports from Argentina over the period 1979-1981, rising to 11% over the period 1982-1984. The PEC, unlike the CAUCE, has had a declining effect and drives a substantially smaller share of exports to Brazil: 18.3% on average over the period 1977-1984. It involved an average 8.5% of imports from Brazil over the same period.

Uruguay showed a trade surplus in products covered by the agreements. But only a small part of Uruguay's imports were channeled through them. In total, Uruguay's final trade balance with the two countries showed an increasing deficit.

In the period 1985-1990, after modifying CAUCE and PEC,³⁸ the total trade balance with Argentina and Brazil was \$5.6 billion in deficit. CAUCE covered, on average, 23.7% of exports and 32.3% of imports to Argentina. Likewise, PEC covered, on average, 55% of exports (73.8% in the last two years) and 31.4% of imports to Brazil. Combined, the trade agreements covered an average of 50% of the trade with the two countries over the last six years. Under the modified agreements, Uruguay's trade balance on goods covered by the agreements continues to be in surplus.

¹⁶ Convenio Argentino-Uruuguayo de Complementación Económica (CAUCE).

¹⁷ Protocolo de Expansión Comercial (PEC).

³⁸ "Acta de Colonia" modifies CAUCE in May 1985 and "Acta de Cooperación Económica Uruguay-Brasil" modifies PEC in August 1986.

The agreements that Uruguay signed with the countries of the region involved negotiations that influenced the trade flows. The negotiations pursued by Uruguay emphasized, in an expressed way, its relatively small size. It basically sought to obtain commercial advantages in the markets of the other participants. These advantages basically involved tariff preferences and eliminated non-tariff barriers.

The scope and method of the negotiation is different for CAUCE and PEC, but there is a common aspect to both negotiations: Uruguay obtained preferential access for a large number of products and it gave grants for products that are not domestically produced and for which there was no protection. The rationale was to obtain benefits in the neighbor's markets without exposing Uruguayan enterprises to the international market, the same policy that Uruguay applied to the rest of the world.

Uruguay seems to have joined regional agreements without large costs, which implies industrial adjustments have been minimal. Uruguay had claimed its small size as a handicap in the bilateral negotiations, and in this way its industrial sector has always been protected.

3. The Evolution of MERCOSUR

The integration process in the Southern Cone of South America, that ended with MERCOSUR's formation, started with bilateral efforts between Argentina and Brazil in November 1985. A timeline of significant milestones in the negotiations is presented in the Appendix. It started with the "declaration of Iguazu" between President Raul Alfonsín of Argentina and José Sarney of Brazil. They subsequently executed the

"declaration of integration" on July 29, 1986. Argentina and Brazil signed a set of sectoral agreements, termed Protocols. Protocols encouraged intra-industry trade and productive, financial and technological cooperation at an intra-industry level. The goal is not to promote sector specialization. This goal is based on examining the European experience and earlier Latin American failures. The 24 signed Protocols focus on cooperating in jointly developing certain sectors: capital goods, energy, nuclear security, transportation, communication, automobiles, industry, biotechnology, processed food, etc. A legal framework for forming bi-national enterprises was also created. These enterprises will have priority in accessing an Investment Fund created to finance capital-investment projects. That sectoral economic integration was expanded by a piecemeal process which later became too cumbersome. Hence, on November 28, 1988, Argentina and Brazil signed a bilateral "Integration Treaty." This committed them to completely phase out all bilateral tariff and non-tariff barriers, setting the stage for MERCOSUR. The treaty provided that the road towards integration would respect certain principles: graduality, flexibility, equality and symmetry. These principles were expected to allow the economic operators of each country to progressively adapt to the new and enlarged conditions of competition. This also indicated concern from both countries for the "asymmetries" between their respective systems and sectors.

From the beginning, Uruguay linked itself politically to the agreements that had signaled a rapprochement between its neighbors. The then Uruguayan President, Julio María Sanguinetti, attended the July 29, 1986 integration meeting between Argentina and

Brazil. His counterparts used the occasion to invite Uruguay to participate in the process. The three presidents signed the "Acta de Alvorada" on April 6, 1988, formally marking Uruguay's gradual and flexible integration into the agreement. Transportation was chosen as the best sector to begin the process. On November 28, 1988, Uruguay extended its participation to public administration, communications and biotechnology.

Paraguay, for its part, could not participate in the process until May 1, 1989. This date marked the first democratic elections in the country since General Alfredo Stroessner took power 36 years previously. Stroessner had established solid economic ties with Brazil, Paraguay's major creditor and main trading partner. In the 1970s, Paraguay also had close links to both Brazil and Argentina through large hydroelectric projects: Itaipú with Brazil, and Corpus and Yacyretá with Argentina. Following the return to democracy, Paraguay has been favorably disposed towards integration, seeking to end the isolation it had experienced during its military rule.

The integration process was boosted by the July 6, 1990 Declaration of Buenos Aires. The declaration called for establishing an Argentine-Brazilian common market by the end of December, 1994. This Declaration evidences important changes when compared with previous agreements. The "Integration Treaty" provided for a 10-year period to complete the bilateral integration process. This period was shortened, showing stronger political will to make the common market a reality. Annex I of the Declaration defined tariff rebates and eliminated non-tariff barriers as the main tools for achieving the

common market. Concerning the former, it provides for a "systematic, general, linear and automatic elimination of tariffs"³⁹ to be completed before December 31, 1994.

On August 1, 1990, in Brasilia, the Argentine and Brazilian Economic and Foreign Ministers met their Chilean and Uruguayan colleagues. The ministers considered creating a Southern Cone common market, and discussed a common stance on the US President Bush's "Enterprise for the Americas Initiative." The four countries invited Paraguay to participate in the process. Chilean representatives stressed that, for the time being, they did not want to go beyond establishing a Southern Cone free trade zone. On August 20, 1990, the Paraguayan Foreign Minister officially announced the decision to join the integration process. On September 5 and 6, 1990, Paraguayan and Uruguayan representatives met a negotiating committee from Argentina and Brazil in Buenos Aires. They agreed to hold a fresh meeting to discuss the Quadripartite Treaty that would substitute for bilateral negotiations on the Southern Cone Common Market. Subsequently, Paraguay and Uruguay have participated as observers in meetings of the Common Market Group, a body set up on July 6, 1990 and entrusted with making proposals on the structure of the common market.

The signing of the treaty, envisaged for the end of November 1990 in Asunción, was postponed to resolve some outstanding issues. Paraguayan and Uruguayan negotiators asked to delay their full integration past December 1994. Both Paraguay and Uruguay also asked for preferential treatment, since their economies and levels of development were relatively inferior. This demand was subsequently dropped. Uruguay

³⁹ Declaration of Buenos Aires, July 6, 1990, Annex I.

had also put forward proposals, such as "proof of origin" for the commodities traded, and safeguard clauses in case of economic instability. Uruguay further favored creating a Tribunal to deal with disputes.

In spite of the difficulties encountered, representatives from the four countries met in Buenos Aires on February 20, 1991. Argentina's Foreign Minister stated that the new Treaty would be signed at the end of March 1991. The Common Market of the Southern Cone (MERCOSUR), was finally set up by Argentina, Brazil, Paraguay and Uruguay on March 26, 1991, when the four countries' presidents signed the Treaty of Asunción, in the capital of Paraguay.

B. PROVISIONS

The Treaty of Asunción has six chapters, that are further divided into 24 articles and five annexes.⁴⁰ MERCOSUR's objective is to establish a free circulation of goods, services and production factors within the four countries, unify customs, coordinate macroeconomic policies (i.e., fiscal, exchange, and monetary policies) and establish an external common tariff for trade with the rest of the world.

The treaty calls for completely eliminating tariffs and non-tariff barriers on intra-regional trade by the end of 1994, using a graduated schedule of tariff reductions.⁴¹ When the treaty entered into force, tariffs were reduced across the board by 47%. They are to be reduced every six months afterwards, until reduced to zero by the end of 1994.⁴²

⁴⁰ Annex I: Program of Trade Liberalization; Annex II: Origin General Regime ; Annex III: Settlement of Controversies; Annex IV: Safeguard Clauses and Annex V: Technical Subgroups.

⁴¹ Annex I, Article 3 of the Treaty of Asunción.

There are some products excepted from this general rule. Each country was allowed to specify a products list that it wished to except from the reduction program.⁴³ These exceptions are only temporary and are subject to their own reduction program. Argentina and Brazil are to reduce these products lists by 20% per year, until all have been removed by the end of 1994. Paraguay and Uruguay are given one extra year to fully eliminate their exceptions.⁴⁴

Although the institutional aspects of MERCOSUR are still being developed, the treaty created two multilateral organizations, in which each country is evenly represented:

- ♦ The MERCOSUR Council, in charge of political issues, formed by the ministers of foreign relations and economics;
- ♦ The MERCOSUR Group, a permanent intergovernmental executive organ coordinated by the foreign ministries and assisted by an Administrative Secretariat based in Montevideo and by technical subgroups (ten were created in Annex V).⁴⁵

Because MERCOSUR will become a customs union, one key feature of the treaty is the external common tariff scheduled for December 31, 1994.⁴⁶ The treaty says only,

⁴³ Article 3 of Annex I: Tariffs are to be reduced according to the following schedule: 54% by December 31, 1991; 61% by June 30, 1992; 68% by December 31, 1992; 75% by June 30, 1993; 82% by December 31, 1993; 89% by June 30, 1994 and 100% by December 31, 1994.

⁴⁴ Article 6 of Annex I: The number of products on each country's list of temporary exception are as follows: Argentina: 394; Brazil: 324; Paraguay: 439 and Uruguay: 960.

⁴⁵ Article 7 of Annex I: Paraguay and Uruguay follow this schedule: 10% when the treaty entered into force; 10% by December 31, 1991; 20% by December 31, 1992; 20% by December 31, 1993; 20% by December 31, 1994; and 20% by December 31, 1995.

⁴⁶ Annex V: In order to coordinate the macroeconomic policies, the MERCOSUR Group will create in the 30 days after its installation, the following technical subgroups: trade affairs, customs affairs, technical norms, fiscal and monetary policies related with trade, land transport, sea transport, industrial and technological policy, agricultural policy, energy policy and coordination of macroeconomic policies.

⁴⁶ Articles 1 and 5 of the Treaty of Asunción.

in Article 5, that the external common tariff has to promote the external competition of the four countries.

Other members of the Latin American Integration Association (LAIA) could participate in this treaty, if all MERCOSUR members unanimously approve them, five years after the treaty entered into force. Members of LAIA that do not join other subregional agreements can demand their acceptance into MERCOSUR within five years.

C. IMPORTANT ISSUES SINCE THE SIGNING OF THE TREATY

Since the signing of the treaty, numerous multilateral meetings at the ministerial and presidential level have strengthened commitments to the treaty provisions. Two summit meetings should be emphasized. The first was held in Brasilia in December 1991. The presidents ratified both the internal regulations of the MERCOSUR Group and an arbitration system for resolving disputes among members.⁴⁷ The second summit was held in Las Leñas, Mendoza, Argentina, in July 1992. There the presidents approved a complete and meticulous timetable coordinating all macroeconomic policies for achieving integration by the first day of 1995.⁴⁸ At a meeting in Asunción on July 1, 1993, the Presidents of the four countries adjusted the timetable for the measures adopted in Las Leñas, following the advice of most of the technical subgroups handling the negotiations. The subgroups' petition argued that it would be difficult to implement the

⁴⁷ "MERCOSUR: New MERCOSUR Regulations" *North American Report on Free Trade*, January 17, 1992.

⁴⁸ "MERCOSUR Countries Signed Timetable for Measures to Implement Common Market" *The British Broadcasting Corporation (BBC) - Summary of World Broadcasts*, July 7, 1992.

timetable. For example, it would be impossible to establish the levels of the common external tariffs for each line of production, as required by the Las Leñas timetable, because it is a very complex problem. The subgroups also suggested that the reformulation would not have any impact on the deadlines for implementing a free trade zone by January 1995.

So far, establishing the common external tariff has been one of the most problematic issues of the agreement. During 1993, at the Trade Affairs and the Macroeconomic Policy Coordination Subgroup meeting, experts were discussing the common external tariff structure. According to a decision made at a December 1992 meeting in Montevideo, external tariffs would range between 0 and 20 percent, with a small list of exceptions that would be protected by a 35 percent tariff. The December 1993 meeting of the presidents of the four countries was suspended due to disagreements and the need to define the common external tariff problem. The things to be defined were: the amount of the common external tariff (indeed, whether there would be one); the deadline for its implementation; and the products on which it would apply.

During a news conference granted to foreign journalists, the President of Uruguay, Luis Alberto Lacalle, said that the commercial relationship between Argentina, Brazil, Paraguay, and Uruguay may result in a "Hybrid" product, "in something that may not have a name," combining the characteristics of a common market with those of a free trade zone. The unique characteristics that may evolve from the subregional integration process in the Southern Cone relate to the "crucial subject" of the common external tariff.

The alleged hybrid was described as "a common market for a significant list of merchandise, and another type of relationship for others."⁴⁹ In January 1994, there were still disagreements between Argentina and Brazil. The controversy stemmed from their different stances on both when the common external tariff should take effect and the tariff level. Brazil did not want investment goods, software, and hardware included in the customs union for five years, and wanted to be protected by a 35 percent tariff. Argentina, in turn, contended that these products had to enter MERCOSUR countries duty-free and that this provision had to be enforced immediately.

There have been coordinated initiatives among all members in other areas, like legislative cooperation,⁵⁰ legal cooperation,⁵¹ and education integration;⁵² as well as new coordinated policies for global problems, like the environment.⁵³ On June 30, in an Asunción meeting of education ministers, a commitment was signed to adopt an equivalent study system at the primary and secondary levels.

It is significant to highlight that MERCOSUR strengthened the potential for negotiating with other countries and trading blocs.⁵⁴ The Asunción Treaty not only calls for establishing common external tariffs for trading with third countries, but also for coordinating positions in regional and international forums. Hence, MERCOSUR

⁴⁹ El País in Spanish, November 21, 1993, pp. 1,14.

⁵⁰ "Basis Set for MERCOSUR Parliament" Xinhua General News Service, September 21, 1991.

⁵¹ "MERCOSUR Justice Ministers Sign Cooperation Agreement". The British Broadcasting Corporation, November 19, 1991.

⁵² "MERCOSUR Member Nations to Integrate Education Programs", Notisur, January 8, 1992.

⁵³ "MERCOSUR Countries Agree on Common Environmental Policy", Notimex-Mexican News Service, February 20, 1992.

⁵⁴ See remarks by Enrique Iglesias quoted in *USA: Washington Letter* "MERCOSUR Step in Right Direction" Reuter-Latin American Report-Southern Cone.

members immediately initiated diplomatic contacts as a group with other economic associations, like the European Community.⁵⁵ This aspect of MERCOSUR was quickly reinforced at the first working meeting among economic ministers in Montevideo. All four countries decided to implement the same foreign trade policy.⁵⁶ For example, all countries decided to develop a coordinated answer to the American President's "Enterprise for the Americas Initiative." This resulted in the so-called "Rose Garden Agreement" signed in Washington on June 19, 1991.⁵⁷ The agreement set a framework to discuss relaxing trade barriers between the United States and MERCOSUR members.



⁵⁵ "EC: Latin American MERCOSUR States Call for a Framework Agreement With the Community" Reuter-Agency Europe, May 1, 1991.

⁵⁶ "MERCOSUR: Ministers Agreed to Implement Coordinated Foreign Trade Policies", The British broadcasting Corporation, July 30, 1991.

⁵⁷ Eberwine, Donna, "Marching Toward a Megamarket", *The Region*, June 1991.

IV. MACROECONOMIC PROFILE OF PARTICIPANTS

The objective of this section is to describe the main macroeconomic characteristics of the MERCOSUR countries. Among the participant countries there are differences in productive structure, their growth and development level, the distribution of employment across different sectors, the public sector's participation in the economy, the levels of external debt, external trade patterns, etc.

A. STRUCTURE AND EVOLUTION OF GNP

In 1970, MERCOSUR countries generated a combined GNP of \$179.4 billion, which represented 44.6% of the GNP of the LAFTA countries (Latin American Free Trade Agreement). In 1980, the GNP of the four countries was \$339.9 billion and in 1990, \$385.2 billion, in constant 1970 dollars. This represents a real annual increase of 6.6% in the first ten years and 1.4% in the following period. The real growth rates for the LAFTA countries are 5.6% and 1.4%, respectively. The relative importance of the MERCOSUR economy in LAFTA increased to 49.2% in the 1980's. This shows the potential that MERCOSUR has for the development process of the LAFTA countries.

Table I shows the relative increase in GNP of the MERCOSUR and LAFTA countries. The data shows the structure and dynamics of the MERCOSUR and LAFTA economies and the magnitude of the changes from 1970 to the end of the 1980s.

TABLE I. RELATIVE GNP AND GROWTH OF THE REGIONAL ECONOMY
(In percentage and constant 1980 values)

	Relative GNP (%)			GROWTH (%)	
	1970	1980	1990	1970/80	1980/90
ARGENTINA	37	25	20	2.6	-1.4
BRAZIL	59	72	77	8.6	2.2
PARAGUAY	1	1	1	8.7	3.2
URUGUAY	3	2	2	3.0	1.7
MERCOSUR	100	100	100	6.6	1.4
LAFTA				5.6	1.4

Source: ECLA (Economic Commission for Latin America)

B. PRODUCTIVE STRUCTURE

In order to describe the MERCOSUR participants productive structure, the United Nations classification will be used. This classification divides production into three sectors: primary, secondary and tertiary. The Primary sector includes: agriculture, forest, hunting, fishing and mining. The Secondary sector includes: construction and basic services. The Tertiary sector includes: trade, finance, government services and other non-basic services. Table II shows the productive structure as a percentage of the GNP for 1990.

TABLE II. 1990 PRODUCTIVE STRUCTURE
(As a percentage of GNP)

	ARGENTINA	BRAZIL	PARAGUAY	URUGUAY
PRIMARY SECTOR	20	11	28	11
SECONDARY SECTOR	40	38	29	38
TERTIARY SECTOR	40	51	43	51
TOTAL	100	100	100	100

Source: ECLA (Economic Commission for Latin America)

It is evident that Argentina, Brazil and Uruguay have a larger secondary sector than Paraguay, due principally to their more developed industrial sector. In 1990, industry in Argentina contributed 21% of GNP ; 23% in Brazil; 25% in Uruguay; and only 16% in Paraguay.

In basic services, it is interesting to see the variance across the four countries. In 1990, this sector was 17% of GNP in Argentina, 10% in Uruguay, 8% in Brazil and Paraguay. The financial sector was particularly important in two countries: Brazil and Uruguay. For Brazil, the finance sector contributed 24% to GNP, while for Uruguay, the sector contributed 23%.

In the case of Paraguay, the most important sectors are agriculture and forest-related products. In 1990 these sectors represented 28% of the economy. This indicates that Paraguay is predominantly agricultural compared to the other MERCOSUR countries. On the other hand, Argentina and Brazil have relatively large industrial sectors and Brazil and Uruguay have relatively large financial sectors.

In agricultural production, the MERCOSUR countries use different processes for producing specific items, and vary in production scale, technology, and quality of natural resources; as a result, there are differences in yields across countries. This helps explain the differences in the production costs and affects comparative advantages for intraregional trade and trade with the rest of the world.

The more industrialized countries are Argentina and Brazil, which actually produce all the necessary items for their industrial development. In the case of Paraguay and

Uruguay, however, the situation is completely different; they do not have the necessary metallurgic and mining resources to diversify their economies and support the development process.

C. POPULATION AND EMPLOYMENT

The total population of MERCOSUR went from 155.6 million people in 1980 to 186.6 million in 1990; the annual growth during this period was 2% (See Table III). Of the total for 1990, the population of Brazil was 79%, 17.1% was Argentinean, 2.2% was Paraguayan and 1.7% was Uruguayan. It is interesting to note the similarity between population and economic structure as a percentage of the MERCOSUR total GNP in the cases of Brazil and Argentina; this relation is reversed for Paraguay and Uruguay (Brazil 77%, Argentina 20%, Paraguay 1% and Uruguay 2%). The 1990 population of MERCOSUR represented 42.8% of the Latin American population. It had been 43.4% in 1980, according to ECLA (Economic Commission for Latin America).

TABLE III. LEVEL AND GROWTH IN THE TOTAL POPULATION
(In thousands of people and percentage)

COUNTRIES	1 9 8 0	1 9 9 0	Growth in %
ARGENTINA	28,237	31,929	1.4
BRAZIL	121,286	147,404	2.2
PARAGUAY	3,147	4,158	3.1
URUGUAY	2,914	3,077	0.6
MERCOSUR	155,584	186,568	2
LATIN AMERICA	358,876	435,663	2.2

Source: ECLA (Economic Commission for Latin America)

The data show the actual size of the MERCOSUR market. It would be better to say "potential market," because there are very large differences in per capita disposable income.

The proportion of the population that is urban has increased significantly between 1970 and 1990. This reflects growth in the secondary and tertiary sectors. Table IV shows the distribution of the population between urban and rural areas for the indicated years.

TABLE IV. DISTRIBUTION OF THE POPULATION BETWEEN URBAN AND RURAL AREAS
(In percentage)

	1 9 7 0		1 9 9 0	
	URBAN	RURAL	URBAN	RURAL
ARGENTINA	78.4	21.6	86.2	13.8
BRAZIL	55.8	44.2	76.9	23.1
PARAGUAY	37.1	62.9	47.5	52.5
URUGUAY	82.1	17.9	90.5	9.5

Source: ECLA (Economic Commission for Latin America)

Comparing the magnitude of the secondary and tertiary sectors in 1970 and 1990 with the proportion of the urban population for the same years shows a certain similarity. In general, these characteristics are comparable, except in the case of Paraguay. Table V shows the composition of the GNP per sector of production.

The active economic population⁵⁸ of MERCOSUR increased from 41.4 million in 1980 to 56.4 million in 1990, an annual growth of 3.1%. The average annual growth for Latin America was 3.3%, (from 88.0 million to 121.6 million). MERCOSUR's work

⁵⁸ "Active economic population" denotes the number of employed individuals over the age of 14.

force decreased slightly from 47.1% to 46.4% compared to the total of LAIA (Latin America Integration Association).

TABLE V COMPOSITION OF GNP PER PRODUCTION SECTORS
(In percentage and in current values)

COUNTRIES	1 9 7 0		1 9 9 0	
	GNP _s +GNP _t	GNP _p	GNP _s +GNP _t	GNP _p
ARGENTINA	85.8	14.2	80	20
BRAZIL	86.8	13.2	89	11
PARAGUAY	67.8	32.2	72	28
URUGUAY	86	14	89	11

Note: GNP_p = Production of Primary Sector
GNP_s = Production of Secondary Sector
GNP_t = Production of Tertiary Sector

Source: ECLA (Economic Commission for Latin America)

The growth rates of the active economic population in each of the MERCOSUR countries for the 1980-1990 period were: Argentina, 0.9%; Brazil, 3.8%; Paraguay, 3.3% and in Uruguay, 0.4%. The proportions of the working force in the total population in 1990 were: Argentina, 32.2%; Brazil, 29.9%; Paraguay, 24.9%, and; Uruguay, 36.9% (See Table VI).

Table VI shows a concentration of the active economic population in the secondary and tertiary sectors in the more developed countries of the region. This is summarized in Table VII, which shows the proportion of the active economic population that is also urban population, the proportion of the active economic population that is employed in secondary and tertiary sectors, and the proportion of GNP from the same sectors.

TABLE VI. STRUCTURE AND EVOLUTION OF THE ACTIVE ECONOMIC POPULATION
(In thousands of persons)

	1 9 8 0			1 9 9 0		
	AGRICULTURE	INDUSTRY	SERVICES	AGRICULTURE	INDUSTRY	SERVICES
ARGENTINA	1,492	3,195	4,131	1,333	3,456	5,430
BRAZIL	13,358	6,589	10,071	13,730	11,721	18,609
PARAGUAY	394	151	204	503	213	320
URUGUAY	203	319	573	177	330	627
MERCOSUR	15,677	10,254	15,479	15,743	15,720	24,986
LAIA	35,950	20,362	31,662	38,926	31,369	51,293
MERCOSUR / LAIA (%)	43.6	50.4	48.9	40.4	50.1	48.7

Source: ECLA (Economic Commission for Latin America)

TABLE VII. URBAN AND ACTIVE ECONOMIC POPULATION AND GNP
OF SECONDARY AND TERTIARY SECTORS
(In percentages)

	URBAN POPULATION	AEP _s + AEP _t	GNP _s + GNP _t
ARGENTINA	86.2	87	80
BRAZIL	76.9	73.8	89
PARAGUAY	47.5	51.4	72
URUGUAY	90.5	81.2	89

Source: ECLA (Economic Commission for Latin America)

The data that have been analyzed show a first approximation of the productive structure of the four MERCOSUR countries. To complement this discussion it is necessary to analyze certain aspects of demand, especially in relation to exports and imports.

D. STRUCTURE AND BEHAVIOR OF THE EXPORTS

The export of MERCOSUR goods increased from a total of \$16.5 billion in 1970 to \$29.6 billion in 1980 and to \$54.2 billion in 1990, at constant 1980 prices.⁵⁴ These data

show that exports expanded 6.0% annually in real terms, during the period 1970-1980, and 6.2% annually for the decade 1980-1990. During the same periods, Latin American exports increased 2.2% and 5.3% annually, respectively. Consequently, the relative importance of MERCOSUR in LAIA exports increased from 23.1% in 1970 to 33.4% in 1980, and to 36.4% in 1990. Table VIII summarizes the above descriptive situation.

TABLE VIII. SHARES IN MERCOSUR EXPORTS OF GOODS

(In percentage)

	COMPOSITION (%)			GROWTH (%)	
	1 9 7 0	1 9 8 0	1 9 9 0	1 9 7 0 / 8 0	1 9 8 0 / 9 0
ARGENTINA	37	27	27	2.1	6.3
BRAZIL	57	68	67	8.2	13
PARAGUAY	1	1	2	7.3	13
URUGUAY	5	4	4	5.1	4.7
MERCOSUR	100	100	100	6	6.2
LAIA				2.2	5.3
MERCOSUR / LAIA (%)	23.1	33.4	36.4		

Source: ECLA (Economic Commission for Latin America)

The structure of exports from MERCOSUR changed noticeably from 1970 to 1990. This change mirrored the composition of the exports per country and per category of products.

In 1970, of the total exports of MERCOSUR goods, 37% came from Argentina, 57% from Brazil, 1% from Paraguay and 5% from Uruguay. In 1990, Argentinean

participation decreased to 27%, Brazil increased its relative share to 67%, Paraguay increased to 2%, and Uruguay decreased to 4%.

The relative contribution of primary products declined from 85% in 1970 to 55% in 1990, while manufactured exports from MERCOSUR increased from 15% in the base year to 45%. These significant changes are basically attributed to Brazil. Its exports of manufactured goods increased from 59% of the total in 1970 to 78% in 1990. However, Brazil also increased its participation in the primary products sector, from 57% to 59% in the indicated years.

The value of goods and services exported increased rapidly in the last two decades, in current values. The indicators reveal that global expansion of the MERCOSUR economies was greater than the countries that form LAIA. For LAIA as a whole, goods and services exports went from \$13,616 million in 1970 to \$121,722 million in 1990. This represents a nominal growth of 11.6%. For MERCOSUR as a whole, goods and services exports increased from \$5,542 million in 1970 to \$53,817 million in 1990. This represents a nominal growth of 12%. In other words, MERCOSUR's goods and services exports increased 9.7 times over the period, while the increase for LAIA was 8.9 times.

Another aspect to consider is the volume of goods exported from the MERCOSUR countries relative to the total volume of goods and services exported. In 1990, the proportion of goods in the total exports of goods and services was 84% for Argentina, 89% for Brazil and 80% for Paraguay and Uruguay. The composition of global exports did not change for Argentina between 1970 and 1990. In Brazil, the production of goods

decreased slightly (from 90 to 89%). Paraguay experienced a noticeable increase in the exports of goods (from 73 to 80%) and Uruguay also increased the export of goods (from 77 to 80%). Table IX lists the relevant values.

TABLE IX. EXPORTS OF GOODS AND SERVICES
(In million and percentage)

	1 9 7 0		1 9 9 0		1 9 7 0 / 8 0
	\$	%	\$	%	GROWTH %
ARGENTINA	2,104	100	14,789	100	10.2
GOODS	1,773	84	12,354	84	10.2
SERVICES	331	16	2,435	16	10.5
BRAZIL	3,059	100	35,167	100	13
GOODS	2,739	90	31,390	89	13
SERVICES	320	10	3,777	11	13.1
PARAGUAY	89	100	1,741	100	16
GOODS	65	73	1,392	80	16.6
SERVICES	24	27	349	20	14.3
URUGUAY	290	100	2,120	100	10.5
GOODS	224	77	1,693	80	10.6
SERVICES	66	23	427	20	9.8
MERCOSUR	5,542	100	53,817	100	12
GOODS	4,801	87	46,829	87	12.1
SERVICES	741	13	6,988	13	11.9

Source: ECLA (Economic Commission for Latin America)

Analyzing the exports of the period 1982-1990 it is possible to conclude the following:

- For Argentina, the real increase varied between 3% and 21% over the period. The only years of contraction were 1984, 1986, and 1987; these rates varied between -2.2 and -12.9%;

- ♦ For Brazil, the real increase was between 2 and 19% in most years. The only years of contraction were 1982, 1986 and 1990; these rates varied between -6.7 and -13.9%;
- ♦ For Paraguay, the real expansion was between 2.5 and 30.2% for all the years except 1983, in which the contraction was -8.4%;
- ♦ For Uruguay, the real increase in the majority of the years was between 0.1 and 10.3%. There was contraction in 1984 and 1987, in which the rates were -6.2 and -7.9, respectively;
- ♦ For Latin America, in all the years considered there were real increases between 0.5 (1986) and 8.8% (1987).

Argentina and Uruguay seem to have a symmetric behavior; the years of prosperity for Argentina are matched by prosperity in Uruguay, and vice versa. The 1984, 1986 and 1987 Argentina contraction was matched by contractions in Uruguay in 1984 and 1987. This allows one to suppose that the contraction of 1986 had a lagging and perhaps cumulative effect in Uruguay. This shows the large interdependence and complementarity between the two economies.

In relation to Brazil, the downfall of its exports in 1982 mirrored the decline of the economic activities in Paraguay in the end of that year and its contraction in the following one. It is possible to suppose that there is a certain symmetry between Brazil and Argentina because the contractions in exports occurred simultaneously in 1986, but in the other years the behavior is asymmetric. Thus, the years of expansions in exports in

Argentina (1982, 1985 and 1988) coincided with contractions in Brazil; the years of large expansion of the Brazilian exports (1983, 1984 and 1987) coincided with contractions in Argentine exports. There are similar situations in the relations between Brazil and Uruguay.

Another aspect to consider is the ratio of goods and services exports relative to GNP, as shown in Table X.

TABLE X. EXPORTS OF GOODS AND SERVICES AS A PERCENT OF GNP
(In percentage of constant values of 1980)

	1 9 7 0	1 9 8 0	1 9 8 5	1 9 9 0
ARGENTINA	12.3	11.6	19.6	23.1
BRAZIL	9.2	9	13.5	13.5
PARAGUAY	15.8	13.9	15.5	32.3
URUGUAY	16.8	22.9	31.5	31.9
LAIA	19.8	14.7	18.3	21.6

Source: ECLA (Economic Commission for Latin America)

From the above table it is possible to draw two general conclusions. During the period 1970-1990, the relative importance of goods and services exports in the economies of the four countries has grown continuously. Argentina increased from 12.3% in 1970 to 23.1% in 1990; Brazil, from 9.2% to 13.5%; Paraguay, from 15.8% to 32.3% and Uruguay from 19.8% to 31.9%. The second is that the ratio of exports to GNP are inverse to the size of the economies. Thus, Brazil, with the most important internal market of MERCOSUR, has the lowest proportion of exports, followed by Argentina, and then Uruguay and Paraguay. One hypothesis is that the most developed countries of MERCOSUR, which also have the largest internal markets, have succeeded in their

program of import substitution, particularly the use of raw materials for domestic production. This has made them more self sufficient and reduced their international sector.

E. STRUCTURE AND BEHAVIOR OF IMPORTS

The goods imported by the MERCOSUR countries, in constant 1980 values, increased from \$17,677 million in 1970 to \$34,692 million in 1980, then decreased to \$24,880 million in 1990. These values represent an annual accumulative growth of 7.0% in the period 1970-1980 and a contraction of 3.3% in the period 1980-1990. Conversely, imports to Latin America showed more positive growth rates during the two periods, going from \$44,187 million in 1970 to \$90,459 million in 1980 and \$87,356 million in 1990. This represents a real increase of 7.4% annually in the first decade and a contraction of only 0.3% annually over the period 1980-1990.

Table XI summarizes the data for 1970 and 1990, showing imports and their evolution for the MERCOSUR participants and for Latin America. Comparing MERCOSUR and Latin America indicates the great regional economic importance of MERCOSUR in Latin America. MERCOSUR largely determines the tendencies at a global level. Regarding the import of goods in current values, similar tendencies are observed, although the values and composition of imports by participant country are different.

TABLE XI. IMPORTS OF GOODS: STRUCTURE AND ANNUAL AVERAGE GROWTH
(In constant millions of 1980 dollars and in %)

	1 9 7 0		1 9 9 0		1970-1980	1980-1990
	\$	%	\$	%	GROWTH	(%)
ARGENTINA	5,043	20	2,908	12	6.4	-11.1
BRAZIL	11,260	64	18,934	76	7.4	-2.9
PARAGUAY	291	2	1,710	7	8.8	9.7
URUGUAY	1,083	6	1,278	5	4.4	1.7
MERCOSUR	17,677	100	24,880	100	7	-3.3
LAIA	44,187		87,356		7.4	-0.3
MERCOSUR/ LAIA (%)	40		28.5			

Source: ECLA (Economic Commission for Latin America)

In 1970, 8% of the imports for MERCOSUR countries were consumption goods. 65% were intermediate goods, 26% were capital goods, 1% was gas and 0.2% were cars. In 1990, consumption goods were 10%, intermediate goods 72%, capital goods 17% and gas and automobiles 1%. Table XII shows this data.

The tendency has been to import less consumption goods and more intermediate goods. 1990 is the exception. This exception was probably to stimulate industrialization in the four countries. Capital goods have been imported in a lower proportion. This probably means a gradual process of import substitution for these categories of goods. This may also be true for intermediate goods. It is also possible that the proportional reduction of capital goods imported could be attributed to recessive situations or depression in the four economies, especially in some years of the 1980s.

TABLE XII. IMPORTS OF GOODS PER ECONOMIC CATEGORIES
STRUCTURE AND EVOLUTION
(In percentage of current values)

	C O M P O S I T I O N (%)				V A R I A T I O N (%)	
	1 9 7 0	1 9 8 0	1 9 8 5	1 9 9 0	1970-1980	1980-1990
CONSUMPTION	8	9	6	10	23.8	-2.1
INTERMEDIATE	65	71	80	72	24.2	-4.1
CAPITAL GOODS	26	19	14	17	19	-5.3
GAS	1				16.8	-13.4
CARS		1			39.6	-12.7
MERCOSUR	100	100	100	100	23	-4.2

Source: ECLA (Economic Commission for Latin America)

Regarding imports at the country level, several observations characterize the period 1970-1990:

- Argentina: Comparing 1970 with 1990, Argentina actually imported a lower proportion of consumption goods, and a larger proportion of intermediate goods. Additionally, capital good imports maintained their relative level in total. In 1990 the import of intermediate goods was 72.5%.
- Brazil: Brazil imports more consumption and intermediate goods and less capital goods than the other MERCOSUR countries. Intermediate goods were 73.9% of imports in 1990, capital goods 15.6%, and consumption goods 10.5%.
- Paraguay: The proportion of consumption and intermediate goods increased from 1970 to 1990. The relative shares in 1990 were: 23.3% and 61.3%, respectively. Capital goods decreased to 15.5%.

- ♦ Uruguay: Consumption and capital goods increased relative to other imports. They represented 13.6% and 25.1% of imports, respectively, in 1990. Intermediate goods decreased relative to other imports, representing 61.2% in 1990.

Total goods and services imported to MERCOSUR went from \$5,700 million in 1970 to \$43,854 million in 1980. This represents an average annual growth of 22.6%. In 1990, the current value of the imports was reduced, to \$33,120 million. This reflects an average annual reduction of 3.1% in nominal terms.

Another aspect to point out is the composition of the imports to MERCOSUR by country. Over the period 1970-1990, Brazil increased its share of the total, from 58% in 1970, to 63% in 1980 and 73% in 1990. Argentina, on the other hand, notably decreased in relative importance, from 35% in 1970 to 19% in 1990. Paraguay and Uruguay experienced less significant changes. Table XIII shows this data.

TABLE XIII. IMPORT OF GOODS AND SERVICES PER COUNTRY
(In percentage of current values)

	C O M P O S I T I O N (%)			V A R I A T I O N (%)	
	1 9 7 0	1 9 8 0	1 9 9 0	1970-1980	1980-1990
ARGENTINA	35	30	19	20.7	-7.9
BRAZIL	58	63	73	23.8	-1.5
PARAGUAY	2	2	4	23.9	4.1
URUGUAY	5	5	4	21	-3.9
MERCOSUR	100	100	100	22.6	-3.1

Source: ECLA (Economic Commission for Latin America)

In the total of MERCOSUR goods and services imports, the relative share of services has varied between 25% and 27%. In relation to each of the countries, the relative share of services has been more variable. It has been between 25 and 38% for

Argentina; between 17 and 24% for Brazil; between 20 and 41% for Paraguay; and between 22 and 37% for Uruguay. In the case of Paraguay, the higher indexes are due to its geographical position. It has higher transport costs and other expenditures in its external trade.

The relative importance of services in MERCOSUR's exports has been lower than the relative importance of the service imports, both in total and for each country. Table XIV illustrates the above conclusions.

TABLE XIV. PERCENTAGE OF SERVICES
IN THE IMPORTS AND EXPORTS OF GOODS AND SERVICES

	1 9 7 0		1 9 8 0		1 9 8 5		1 9 9 0	
	X	M	X	M	X	M	X	M
ARGENTINA	16	25	19	28	16	33	16	38
BRAZIL	10	24	8	17	8	22	11	24
PARAGUAY	27	22	29	20	25	41	20	32
URUGUAY	23	37	31	22	32	35	20	24
MERCOSUR	13	25	12	21	11	26	13	27

Source: ECLA (Economic Commission for Latin America)

Analyzing the data from 1982-1990 indicates that the real value of goods and services imports generally decreased. The contraction is larger than in the case of exports.

- Argentina: The years of the increase in its imports were 1984, 1986, 1987 and 1989, and the indexes oscillated between 5.7 and 20.2%. The other years were of real contraction and the variation coefficients varied between -9.5 and -43.0%.

- ♦ Brazil: The only years of growth were 1986, 1989 and 1990, with rates varying between 9.1 and 21.9%. The rest of the years were real contractions and the coefficients varied between -1.4 and -18.5%.
- ♦ Paraguay: The expansion years were 1984, 1988 and 1990, with rates that oscillated between 0.7 and 44.4%. The other years were of contraction and the indexes oscillated between -1.4 and -23.7%.
- ♦ Uruguay: There were only increases in 1986 and 1987, of 25.9 and 14.1%, respectively. The rest of the years were of significant contraction, with rates that oscillated between -0.3 and -20.3%.
- ♦ Latin America: Experienced zero growth in 1986 and expansion in 1984 and 1986-1990, with a rate that varied between 1.2% and 8.4%. The other years were contractionary, with indexes that oscillated between -18.1% and -23.5%.

In general the most developed MERCOSUR countries show lower imports, relative to GNP, than exports. Table XV shows this is generally true in most of the years analyzed. In the case of Paraguay, on the other hand, the situation is reversed. Imports are higher relative to GNP than exports. Uruguay's situation varies by year.

Tables XVI and XVII summarize the data related to intraregional trade for 1980 and 1990. Only Brazil has a positive balance of trade with MERCOSUR and with LAIA in 1980, as illustrated in Table XVI.

TABLE XV. COEFFICIENTS OF EXPORT AND IMPORTS
(In percentage of GNP at a constant values of 1980)

	1 9 7 0		1 9 8 0		1 9 9 0	
	X / GNP	M / GNP	X / GNP	M / GNP	X / GNP	M / GNP
ARGENTINA	12.3	9.4	11.6	15.4	23.1	5.7
BRAZIL	9.2	12.3	11.4	9	13.5	8.2
PARAGUAY	15.8	19.3	13.9	20.7	32.3	35
URUGUAY	16.8	26.5	22.9	32.2	31.9	21.7
LAIA	19.8	13.5	14.7	16.4	21.6	13.2

NOTE: X/GNP = Coefficient of exports

M/GNP = Coefficient of imports

Source: ECLA (Economic Commission for Latin America)

TABLE XVI. INTRAREGIONAL TRADE OF GOODS IN 1980
TRADE BALANCE OF EACH COUNTRY WITH MERCOSUR AND LAIA
(In million of dollars FOB)

	M E R C O S U R			L A I A		
	X	M	BALANCE	X	M	BALANCE
ARGENTINA	1,139.8	1,308.5	-168.7	1,850.5	2,118.9	-268.4
BRAZIL	1,812.0	996.3	815.7	3,459.0	2,675.5	783.5
PARAGUAY	124.6	613	-488.4	140.6	622.1	-481.5
URUGUAY	347.9	506.5	-158.6	393.4	640.9	-247.5

Source: ECLA (Economic Commission for Latin America)

TABLE XVII. INTRAREGIONAL TRADE OF GOODS IN 1990
TRADE BALANCE OF EACH COUNTRY WITH MERCOSUR AND LAIA
(In million of dollars FOB)

	M E R C O S U R			L A I A		
	X	M	BALANCE	X	M	BALANCE
ARGENTINA	1,428.4	833.7	594.7	2,837.9	1,434.9	953.5
BRAZIL	1,367.0	1,906.3	-539.3	3,476.0	2,928.7	548
PARAGUAY	395.8	425.9	-30.1	422.7	443.6	-20.9
URUGUAY	525.7	551	-25.3	588.3	642.7	-54.4

Source: ECLA (Economic Commission for Latin America)

F. BALANCE OF PAYMENTS: 1980-1990

Table XVIII shows the principal accounts of the Balance of Payment, expressed in current values for the period 1980-1990. The data indicate that each of the MERCOSUR countries have negative balances; there is a long-standing deficit in most cases in the Current Account and Global Balance of Payment. The Capital Account has a positive balance in all periods to offset the Current Account deficit. Its importance has diminished, however, because of lower direct investment and short-term pressure regarding credit to suppliers. Table XVIII lists external sector balances.

TABLE XVIII. EXTERNAL SECTOR - PERIOD 1980-1990
(In million of dollars)

	ARGENTINA	BRAZIL	PARAGUAY	URUGUAY
CURRENT ACC.	-25,904	-51,581	-2,728	-1,568
GLOBAL BAL.	-6,641	-1,158	41	405
CAPITAL ACC.	19,263	50,423	2,769	1,973

Source: ECLA (Economic Commission for Latin America)

G. EXTERNAL DEBT

The stock of external debt of the MERCOSUR countries increased from a total of \$100,726 million in 1980 to \$196,346 million in 1990. This represents an annual expansion of 7% in nominal values, and 2.1% in real terms.⁶⁰ On the other hand, the external debt of Latin America went from \$228,236 million in 1980 to \$421,632 million in 1990, an annual average increase in nominal value of 6.3%, and an annual rate of

⁶⁰ In constant 1990 dollars, the stock of external debt of the MERCOSUR countries for 1980 was \$159,167 million.

1.6%.⁶¹ Therefore, the MERCOSUR countries share of external debt increased from 44.1% in 1980 to 46.6% in 1990.

In relation to the distribution of the external debt across countries, Brazil had the highest debt in 1980, with 70% of the total, followed by Argentina with 27%, Uruguay, 2% and Paraguay, 1%. These relations varied slightly for 1990 because Brazil reduced its share to 62%, Argentina increased to 33% and Uruguay increased to 4%. Paraguay did not change.

Table XIX compares external debt and GNP, both on a per capita basis, in each country over the period 1970-1990. Figure 1 relates external debt to GNP.

TABLE XIX. EXTERNAL DEBT AND GNP PER CAPITA

	1970		1980		1990	
	EXTERNAL DEBT _c	GNP _c	EXTERNAL DEBT _c	GNP _c	EXTERNAL DEBT _c	GNP _c
ARGENTINA	105	2,839	963	3,010	1,983	2,354
BRAZIL	49	1,110	581	2,018	781	2,020
PARAGUAY	64	723	320	1,180	487	1,296
URUGUAY	162	2,453	691	2,033	2,273	2,254

Source: ECLA (Economic Commission for Latin America)

H. BEHAVIOR OF THE INVESTMENTS IN RELATION WITH THE GNP

The investment rate of MERCOSUR countries has varied significantly in recent years, as measured by internal investment relative to GNP. The ratios peaked in 1980, and then declined thereafter. In general, the reductions have been significant. They are

⁶¹ In constant 1990 dollars, the external debt of Latin America for 1980 was \$360,657 million.

typically explained by the movement of capital and other adverse factors. Such factors include the state's assumption of private sector debt, financial speculation, and lack of confidence in economic policy. Table XX illustrates this behavior.

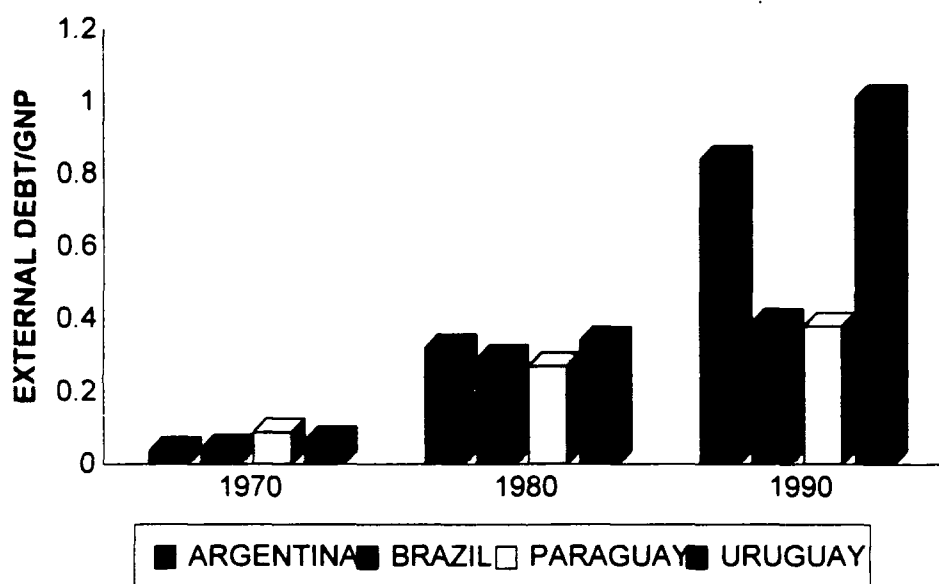


Figure 1. External Debt/GNP Ratio.

TABLE XX. INVESTMENT
(In percentages of GNP)

	1970	1980	1985	1990
ARGENTINA	20.4	22.7	10.1	8
BRAZIL	21.5	23.3	18.5	16.1
PARAGUAY	12.4	28.8	20.9	23.7
URUGUAY	13.7	24.8	10.3	9.6
LAIA	18.3	24.4	16.9	15.6

Source: ECLA (Economic Commission for Latin America)

I. PUBLIC SECTOR PARTICIPATION

The magnitude of the Public Sector in the economies of the four countries can be seen through governmental consumption. Governmental consumption relative to GNP, as shown in Table XXI, really indicates the magnitude of the Public Sector.

TABLE XXI. GOVERNMENT CONSUMPTION AS A PERCENT OF GNP

YEARS	ARGENTINA	BRAZIL	PARAGUAY	URUGUAY	LAIA
1 9 7 0	10.4	11.3	8.7	15.3	10.1
1 9 8 0	8.8	9.2	6.3	12.5	10.7
1 9 8 5	9.5	9.7	6.9	13.5	11.6
1 9 9 0	9.8	12.1	7.2	13	11.1

Source: ECLA (Economic Commission for Latin America)

J. PRICES

The behavior of prices between 1980 and 1990, measured by the GNP deflator and the Consumer Price Index, gives a general impression that these countries are not in a stable equilibrium. Perhaps it forewarns of difficulties to overcome to obtain short run stability in the system, through adjustments of economic policy.

At the MERCOSUR level, the efforts would have to be very important before the countries would harmonize macroeconomic policies. Coordinated macroeconomic policies are likely to affect each country differently. Coordinated policies to control inflation would have to address this concern.

The inflation problems of the MERCOSUR participants must be overcome in the short run. Inflation affects not only the individual country, but also the other

MERCOSUR members. It adversely affects the Balance of Payments and the movement of goods and services among the participant countries. It also affects the capitalization rate, industrialization and, in general, social development. Table XXII shows the large differences in inflation during the period 1980-1990 among the four countries.

TABLE XXII. PRICE INDEXES
(Annual Average Growth)

	1 9 8 0 - 1 9 8 5	1 9 8 5 - 1 9 9 0
ARGENTINA		
GROWTH GNP DEFLATOR	336.6	564.7
GROWTH CPI	322.6	583.8
BRAZIL		
GROWTH GNP DEFLATOR	153.9	632.8
GROWTH CPI	135.1	623
PARAGUAY		
GROWTH GNP DEFLATOR	17.2	30.8
GROWTH CPI	15.8	28
URUGUAY		
GROWTH GNP DEFLATOR	45.6	76.2
GROWTH CPI	44.8	78.2

Source: ECLA (Economic Commission for Latin America)

V. IMPACTS OF MERCOSUR

In the MERCOSUR negotiations, two topics were particularly controversial: coordinating macroeconomic policies (monetary policies in particular); and establishing external common tariffs. The latter must be established by the end of 1994.

The four MERCOSUR participants have taken different positions during the negotiations: Brazil, and to a lesser extent Argentina, have proposed a higher tariff than desired by Paraguay and Uruguay. In this analysis, only Argentina and Brazil will be considered, because Uruguay has extensive trade relations with them.

The different evolutions of the three countries' industrial structures explain the different positions. Uruguayan industry is specialized and based on agriculture. Argentina's intermediate goods, and Brazil's capital goods have earned an important position for the two countries in the world market.

Argentinean-Brazilian integration and the formation of MERCOSUR coincided with a period of open trade with third world countries and declining administrative controls in the three participant countries. There was, in general, a convergence of policies favoring a Customs Union. Nevertheless, agreement about which sectors to protect would be difficult.

A. TRADE POLICIES AND TARIFF STRUCTURE

Until the end of the 1980s, Brazil's import policy was characterized by both non-tariff barriers (quotas, etc.) and high tariffs, which protected markets for local manufacturers.⁶² There were also special import measures that facilitated raw materials and capital goods imports. In 1987, Brazil eliminated some non-tariff barriers by adopting GATT codes, but it was in 1990, during President Collor's government, that the CACEX list of prohibited imports was annulled (CACEX is the bureau that previously operated as the principal instrument of protection).⁶³ Collor also established a schedule for tariff reduction that will end in December 1994 with an average tariff of 20% and a maximum tariff of 40% for infant industries.

In Argentina, after a period of tariff reduction and monetary reform (1976-1980), an import measure was adopted that prohibited certain import goods and required prior authorization for others. The net result was a 48% custom tariff, an average tariff of 27%, and additional non-tariff measures (import quotas, national fund to export promotion (FOPEX), etc.).⁶⁴ This represents less protection than existed prior to 1976. In 1987, Argentina significantly reduced tariff and non-tariff barriers. President Menem's administration enacted four levels of formal nominal protection (35, 22, 11 and 0%) with an average of 12.7% (import quotas and FOPEX included).⁶⁵

⁶² Mesquita Machado y Tavares de Araujo, *Impacto das Políticas Comercial e Cambial sobre Padrao de Comercio Internacional dos Países da ALADI: o Caso do Brasil*, mimeo, UNICAMP, 1992.

⁶³ Mesquita Machado, Joao, *Integracao Economica e Tarifa Aduaneira Comun no Cone Sul*, en Seminario Uruguay en el MERCOSUR, UCLUDAL, 1991.

⁶⁴ Ibid

⁶⁵ Kosacoff Bernardo y Azpiazu, Daniel, *La Industria Argentina: Desarrollo y Cambios Estructurales*, Centro Editor de América Latina, ECLA, Buenos Aires, 1989.

In Uruguay, the process of import liberalization began in 1974. Over the period 1974-1979, non-tariff barriers (quotas, requirements for permission to import, etc.) were eliminated and tariffs were reduced. In January, 1980 a schedule to reduce tariff protection was established. The program was to be accomplished in five years, resulting in a basic tariff of 35% as of January 1985. At the beginning of this program there were 28 tariff levels, the highest tariff was 116% and the simple average of the different tariffs was 49%. In November 1982, simultaneously with a change in the exchange rate, this program was abandoned. At that time, three reductions had taken place; the number of tariff levels had been reduced to 8, the highest tariff was 75% and the simple average of the different tariffs was 36%.

In January 1983 a new program was implemented. Instead of the single tariff level anticipated in the previous program, five levels were to be established. These levels were based on the characteristics and economic purposes of the goods and the regulation necessary to maintain effective protection. The import of raw materials not available in Uruguay were burdened with the minimum tariff, 10%. Intermediate goods and goods with industrial added value received tariffs of 20, 35, and 45%. Products for final consumption had a 55% tariff. In June 1985, due to fiscal problems, an additional surcharge of 5% was established at each level. The surcharge was abolished in August 1986, and the highest tariff level was reduced from 55% to 50%. In August 1987, the three highest tariff levels were reduced, to 45, 40 and 30%. The legal framework was completed by eliminating the minimum tariff of 10% for agriculture factor inputs and

eliminating all tariffs on machinery and industrial equipment for manufacturing firms that transform national raw materials.⁶⁶ In 1990, the government announced its intention to further reduce tariffs. The goal is a maximum tariff of 15%, and the tariff structure again includes steps. Minimum export prices and reference prices remained in force, to control dumping. However, there are still non-tariff protections that increase the internal price of imported goods.

In this context, economists maintain that there are good prospects for agreeing on the external common tariff: the three countries are eliminating non-tariff barriers, there is a common tendency toward lowering the average tariff, and the tariff structure of Brazil is similar to that of Argentina. The industrial policies of the three countries seem to be guided by improving the competitiveness of their respective industrial sectors.

While this conclusion would seem valid in general terms, one must consider the different evolutions of the three countries' industrial structures (the differences in size of the internal markets). This creates a different baseline situation for each country. Despite openness of the Brazilian economy, they still use tariffs to protect their industrialization process. Given their continuous policy of import substitution, their selective tariffs seem consistent with earlier policies. Having reached a point where Brazil produces capital goods, Brazil wants to promote industrial efficiency and domestically incorporate technology.⁶⁷ It would be improbable that the country would abandon the pragmatism that

⁶⁶ Luis Macadar, *Protección, Ventajas Comparadas y Eficiencia Industrial*, Revista Suma, 1988.

⁶⁷ Francisco Rezek, *Una Política Comercial para los Nuevos Tiempos*, Revista Conexión, Diciembre 1991.

has characterized its industrial development policies. Its chosen option would seem to be a delicate balance between import substitution and openness. Its future evolution would be very difficult to estimate with precision. In the cases of Argentina and Uruguay, openness is designed to achieve efficiency by aligning production to their comparative advantages. This involves considering natural resources before technological dynamics. Table XXIII shows the average tariff on a bundle of products for Uruguay, Argentina and Brazil (both 1990 and projected 1994) calculated using the harmonized system of denomination and classification of goods.

In 1990, the three countries generally gave greater protection to certain groups of products: footwear, diverse manufactures, stone and cement products, tools and metal common products, and textiles (for Uruguay, the average tariff of these product groups is closer to the total weighted average). Closer to its respective averages for each country, the second highest level of protection is generally given to plastic, paper and capital goods.

Transport equipment and optic and photography industries have a very high level of nominal protection in Brazil while they receive lower than average tariffs in the other two countries. Similarly, the chemical industry, which produces important industrial inputs, has relatively low tariffs in Argentina and Uruguay, and relative high tariffs in Brazil.

The average tariff on agricultural products is close to the total weighted average in all three countries.⁶⁸ Finally, Brazil has a lower tariff in mining products while Uruguay imposes a relatively high tariff on these goods.

⁶⁸ The aggregation could hide important differences: Brazil and Uruguay protect prepared

Summarizing, Brazil established priorities to protect domestic production in transport equipment, optic and photography and capital goods. Brazilian protection of capital goods and factory inputs would be an important source of conflict with Uruguay. In Uruguay, the lowest tariffs are in the areas of transport equipment, chemicals and cast iron and steel.

TABLE XXIII. EXTERNAL TARIFF
(Averages of the products group)

	URUGUAY	ARGENTINA	BRAZIL	BRAZIL
	1 9 9 0	1 9 9 0	1 9 9 0	1 9 9 4
Agriculture Prods.	26	15	34	13
Mining Prods.	22	16	7	0
Chemical Prods.	15	12	25	12
Plastic Prods.	27	18	31	15
Leather Prods.	24	19	29	13
Wood Prods.	33	21	21	8
Paper Prods.	27	18	23	9
Textile Prods.	29	23	44	17
Footwear	34	24	54	20
Stone & Cement Prods.	31	21	33	10
Cast iron & steel	20	17	21	12
Non-ferrous	28	19	19	11
Tools and Metal Prods.	31	21	31	15
Capital Goods	26	18	31	18
Transport materials	21	15	47	21
Optic & Photography	22	16	35	18
Diverse Manufactures	31	19	54	17
Total weighted average	27	18	32	14

Source: ECLA (Economic Commission for Latin America)

food, beverage and tobaccos, and Argentina oil and greases. In the primary sector, Argentina and Uruguay have very high tariffs for vegetable products and there is also a higher animal products tariff in Uruguay.

These divergences are not emphasized in Brazil's projected tariff structure. While Brazil's projected structure significantly reduces tariffs across the board, the relative priorities conflict with Uruguay. Capital goods would be among the four most protected groups.⁶⁹

As a general problem, this analysis overstates the harmonization across countries for at least two reasons. First, weighted averages can understate the highest tariff products in each industry. These products are the most relevant to the harmonization problem. In 1990, Brazil had a maximum tariff of 105% (85% in capital goods) and Uruguay 40%. Second, Brazil has a larger tariff dispersion than Uruguay, and its structure tends to elevate protection according to the value added in each product. Each industry group contains goods with diverse added value. Very high and very low tariffs exist in the same group. In some cases, the difference in tariffs across the group is so extreme that they cancel one another when taking the group average.

The negotiations, so far, have specified that the common external tariff would be a weighted average of the participants' previous tariffs. Brazil, however, is responsible for more than 60% of regional imports, so its structure will play a large role in establishing the common external tariff.

To approximate Uruguay's costs and benefits and possible alternative actions, it is important to consider the actual regional trade structure and the nature of each participant's trade with the rest of the world. Table XXIV presents an overview, with average data over the period 1985-1990.

⁶⁹ The data has to be taken as an indicator, because the it is aggregated.

TABLE XXIV. TRADE RELATIONS IN THE SOUTHERN CONE				
EXPORTER	IMPORTER			
	BRAZIL	ARGENTINA	REST OF THE WORLD	URUGUAY
BRAZIL	-----	Cap goods 188 Chemicals 33 Metals 89 (89%)	Food 6306 Cap goods 4247 Chemicals 2905 (56%)	Cap goods 69 Chemicals 49 Agriculture 19 (79%)
ARGENTINA	Chemicals 96 Food 95 Agriculture 47 (72%)	-----	Agriculture 2401 Food 2243 Chemicals 529 (77%)	Chemicals 31 Cap goods 19 Agriculture 11 (62%)
REST OF THE WORLD	Oil 5295 Cap goods 3695 Chemicals 2471 (79%)	Cap goods 1629 Chemicals 1274 Oil 164 (79%)	-----	Oil 191 Cap goods 126 Chemicals 119 (84%)
URUGUAY	Food 101 Chemicals 39 Textiles 29 (84%)	Chemicals 27 Textiles 18 Cap goods 17 (65%)	Textiles 362 Food 193 Agriculture 99 (89%)	-----

Source: Based on data of ECLA (Economic Commission for Latin America)

Note: Each category is listed with the value of goods in millions of current dollars. The amount between the brackets is the percentage that the three terms represent in imports from the country. "Food" refers to processed foods.

Brazil has a relatively homogeneous trade pattern with the rest of the world (in the sense that its imports are very similar to its exports). The trade patterns between Argentina and the rest of the world and Uruguay and the rest of the world are largely inter-industry. Trade relations between Argentina and Brazil and Uruguay and Brazil are more similar to those that Argentina and Uruguay have with the rest of the world, than to the type of trade that they have between each other.

Uruguay specializes in textiles and food, and Argentina in food and agricultural products. Both sell food to Brazil and to the rest of the world, while Brazil sells food

only to the rest of the world. The inter-industry Uruguayan specialization is more marked when the partner is more industrially developed. It is well defined with the rest of the world (including, principally the countries of the OECD), less clear with Brazil, and even less with Argentina.

The differences between the bilateral patterns of Uruguay with Argentina and with Brazil in recent years are not particularly important. Uruguayan exports to Brazil have been diversified and are becoming more similar to its exports to Argentina.⁷⁰

Brazil and the rest of the world supply capital goods to MERCOSUR participants. Argentina and Uruguay export only capital goods to one another.⁷¹ It is important to point out the relevance of chemical products in the region's trade. Uruguay purchases capital goods and chemicals (general industrial inputs) from MERCOSUR and from the rest of the world. This could be a source of conflict. Uruguay would prefer low tariffs on these goods and could shift demand from Brazil to the rest of the world. Brazil would increase tariffs on these goods.

Another observation is the relative importance of regional trade for the three countries. Opening the Uruguayan economy has increased its trade with its neighbors, especially since signing the CAUCE (Argentinean-Uruguayan Convention for Economic Complementarity) and PEC (Increased Trade Protocol) agreements in the mid-1970s and then expanding them in the mid-1980s. Because of these agreements, an important group

⁷⁰ Berreta, Nora y Paolino, Carlos, *Comercio con Argentina y Brasil: Uno o Dos Patrones de Inserción Regional?* Sextas Jornadas Anuales de Economía, Banco Central del Uruguay, Montevideo, 1991.

⁷¹ Argentina exports capital goods to Brazil, but these represent only 6% of Argentina's total exports. However, for this analysis only the three more important products among the total exports of each country were considered.

of industries, that once produced only for the internal market, now participates in regional markets.

B. ELEMENTS FOR A URUGUAYAN STRATEGY WITH RESPECT TO THE COMMON EXTERNAL TARIFF

Uruguayan strategy regarding the common external tariff should consider the costs and benefits including, the following aspects: Uruguay's asymmetry in size and level of industrial development with respect to Argentina and Brazil; the great importance of regional trade in its total trade; and the fact that the negotiation process was proposed and encouraged by the agreements between Argentina and Brazil. In addition, it must be noted that the higher tariff structures desired by Argentina and Brazil will differ in absolute and relative values from that desired by Uruguay.⁷²

Bearing this in mind, there are two possible actions for Uruguay:

- Accept a common external tariff similar to the Brazilian structure projected for 1994; in this way Uruguay would participate in a customs union.
- Not accept the common external tariff and establish a lower external tariff for trade with the rest of the world, particularly in capital goods.

The latter decision would mean that Uruguay would stand outside the process or partially participate. Uruguay would reduce tariffs with the participant countries to zero but would maintain its own external tariff (as in the case of the agreement between

⁷² This assumption is consistent with press information regarding negotiations. Argentina seems to agree with Brazil on a higher average level.

United States and Mexico). This decision would place Uruguay in a free trade zone, while Argentina and Brazil would participate in a customs union.⁷³ This option would require that Argentina and Brazil accept Uruguay's strategy and not establish a different tariff for trade with Uruguay.

These two possibilities are not the only possible results. The instruments of policy that are being negotiated and their precise results depend on the positions that each country assumes, on their respective bargaining power, and on how they manage the negotiations.

Each of the above options would have costs and benefits that need to be analyzed. To do this, elements of traditional trade and integration theory must be combined with concepts relating to international trade involving a small country, and elements of the new theory of international trade. Additionally, one must consider the relationship between openness and development among countries with different degrees of industrial and technological development. The purpose of this analysis is to introduce a general framework within which to analyze the possibility of direct foreign investment.

1. Perspectives of traditional trade theory

Vousden (1990)⁷⁴ points out that a free trade zone is not stable as long as the members have different external tariffs and geographic proximity. In such a situation, prices gravitate toward those of the country with the lower tariff, eliminating the effects

⁷³ Paraguay could also be analyzed separately; perhaps its situation would be similar that of Uruguay.

⁷⁴ Vousden, Neil *The Economics of Trade Protection*, Cambridge University Press, New York, 1990.

of the higher tariffs in the other countries. This undercutting of tariffs could, however, be offset by limiting the free movement of goods. This solution would apply only if it is possible to certify the origin of goods imported into the free trade zone by the partner with a lower tariff.

The seminal contribution to the theory of economic integration is the work of Jacob Viner (1950).⁷⁵ He used a Ricardian model to show that the welfare effects of a customs union are ambiguous. Customs unions have two opposing effects: trade creation and trade diversion. Trade creation occurs if the union replaces the high-cost domestic production of one member country by the low-cost production from another. Trade diversion can occur if intra-union restrictions are removed in member countries while retaining restrictions on third-country trade. Trade diversion involves replacing a low-cost third country producer by a high-cost union producer. The customs union can increase welfare by creating trade among the member countries at the expense of inefficient domestic industries in the member countries. As resources are used more efficiently, prices fall and social utility increases. In contrast, the customs union can increase trade among members at the expense of more efficient industries in nonmember countries. This would imply a lower welfare than under free trade, partly due to the lost tariff revenues for goods where trade with the rest of the world is displaced by trade within the union.⁷⁶ Clearly, welfare increases if a policy of trade creation predominates.

⁷⁵ Viner, Jacob, *The Customs Union Issue*. New York: Carnegie Endowment for International Peace, 1950.

⁷⁶ The assumption here is that the government distributes the tariffs in a non-distortional way.

Murray Kemp and Henry Wan (1976), drawing inspiration from an earlier effort by Ohyama, proposed an alternative theoretical approach.⁷⁷ Using the concepts of trade creation and trade diversion they showed that any group of countries could always form a customs union, with a common external tariff, having two desired properties. First, nonmember's welfare would remain unchanged. Secondly, the members would improve their own welfare. Theoretically, this is an important contribution because it shows that preferential groupings can always be devised, in principle, for any given subset of countries, such that they are a Pareto-improvement over the preunion situation. Pareto-improvement means that no country within the union is worse off and at least one is better off. The key to the Kemp-Wan result is that they, unlike Viner, let the common external tariff become a policy variable that is set to achieve the Pareto outcome. The countries that form a customs union would benefit, provided they implement a transference system that compensates the losers and that the common external tariff does not change the region's trade pattern with the rest of the world. These do not seem to be the criteria used to establish the 1994 Brazilian tariff, upon which the common external tariff of MERCOSUR would be based. MERCOSUR's framework does not consider compensating the trade imbalances through investment for reconversion (though it was present in the capital goods protocol between Argentina and Brazil). Thus, the previous general result is not an argument favoring a customs union in this case.

⁷⁷ Kemp, Murray and H. Wan, *An Elementary Proposition Concerning the Formation of Customs Unions*, *Journal of International Economics*, January 1976, p.95-98.

Berreta and Lorenzo (1990) estimate that the effects of trade diversion were not significant over the period 1975-1988, when the PEC and CAUCE agreements were in effect.⁷⁸ However, Roldós (1991) points out that Uruguay maintained much lower tariffs in these goods prior to the agreements.⁷⁹ The free trade zone, even with a lower common external tariff, preserves preference for regional imports for goods subject to quotas or tariffs. In a customs union, assuming a higher common tariff with third party countries, the preference margin for regional goods is greater than in the free trade zone. Hence, corresponding trade diversion increases. This would be a primary argument in favor of a free trade zone.⁸⁰

The effects of modifying trade policy can be more easily analyzed by simplifying the regional trade structure. First, assume Uruguay does not import those goods that it produces domestically. Second, because Uruguay is small in terms of regional and world output, assume Uruguay's trade volume has no effect on regional or world production costs or price. Third, assume Uruguay's current tariff structure is the same for the region and the rest of the world. Thus, current prices are determined by non-tariff prices, i.e. $P_r t > P_w t$ if $P_r > P_w$ and vice versa (where P_r and P_w are prices from the region and rest of the world, respectively, and t is Uruguay's tariff). Fourth, assume that P_r does not equal P_w . Combining the second, third, and fourth assumptions implies

⁷⁸ Berreta, Nora and Lorenzo, Fernando, *Los Costos de la Integración: Desvío y Creación de Comercio en la Región*, Quintas Jornadas Anuales de Economía, BCU, Montevideo, 1990.

⁷⁹ Roldós, Jorge, *MERCOSUR, Política Comercial Óptima?*, Boletín Ceres (6), Montevideo, 1991.

⁸⁰ Also, the customs union option could generate negative protection for agricultural industries if capital goods and inputs for this activity are imported from non-member countries. The present analysis considers only formal nominal protection.

that products are either imported from the region or from the rest of the world. Uruguay does not import the same product from the region and the rest of the world. Finally, assume all regional tariffs are zero in either a free trade zone or a customs union.

As a starting point, consider the case where the world price of a product is greater than its regional price (Figure 2). Uruguay's demand curve for product X is D, and the tariff imposed on imports of X is equal to t . In this case, Uruguay is actually buying (Q_1) from the region. Reducing the regional tariff to zero increases imports ($Q_2 - Q_1$) due to the lower price. Tariff revenue decreases by $Q_1 t$ (rectangle $P_{r1}P_{r2}AB$), but there is a larger increase in consumer surplus (area $P_{r1}P_{r2}AC$).⁸¹ Therefore, there is a net gain (triangle ABC). There will be trade creation, but no diversion, because there will be no shift from efficient producers to inefficient ones. Uruguayan welfare will increase. These conclusions hold whether Uruguay enters a free trade zone or a customs union, because a possible increase in tariffs on goods from the rest of the world will not affect the present analysis.⁸²

⁸¹ Consumer surplus measures how much better off individuals in the aggregate are by being able to buy a good in the market. It is the extra satisfaction or utility gained by consumers from paying actual prices for goods that are lower than the consumers would have been prepared to pay.

⁸² The analysis presented here only considers the microeconomic impacts that the trade policy has on trade patterns, tariff revenues, and consumer surplus for specific industries. Macroeconomic effects, including overall trade balances and employment rates, are largely determined by macroeconomic monetary and fiscal policies. Therefore, these effects are not analyzed here.

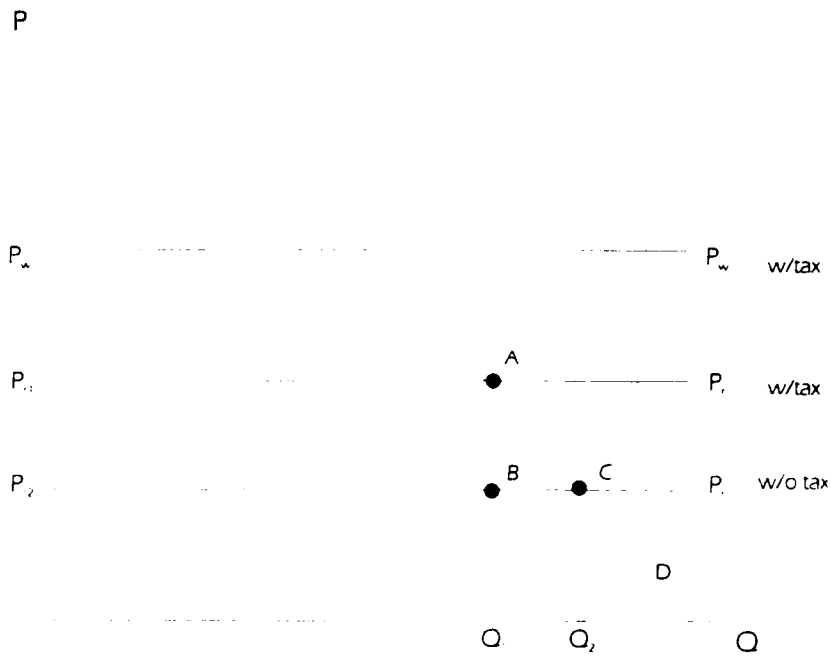


Figure 2. Tariff Revenue and Consumer Surplus: World Prices Higher than Regional Prices.

Next, consider the case where the regional price is greater than the world price. In this case, Uruguay currently buys from the rest of the world. With regional tariff reduction, regional prices can be: (1) lower than the world price plus the Uruguayan tariff or (2) higher than the world price plus the tariff.

In the first instance (Figure 3), tariff reduction causes Uruguay to import Q_2 from the region, instead of Q_1 from the rest of the world; Uruguay loses tariff revenues on imports from the rest of the world, represented by Q_1t (rectangle $P_w P_w + t DA$). However, consumer surplus will increase by area $P_w P_r AC$. Uruguayan welfare would

increase if the area of triangle ABC is greater than that of rectangle $P_{r2}P_{w2}BD$. The size of these areas depends on the value of P_{w2} relative to P_{r2} and the elasticity of the demand curve. This case involves both trade creation and diversion effects. As regional tariffs are reduced, imports increase from Q_1 to Q_2 , but are more costly. Regional imports displace imports which could be produced more efficiently by the rest of the world.

If Uruguay plans to retain its tariffs on imports from the rest of the world, a free trade zone and customs union are equivalent. Increasing world tariffs in a customs union would not affect these results. However, Uruguay would be better off if it entered a free trade zone and eliminated its tariffs on imports from the rest of the world. Uruguay's imports would increase to Q_3 , and it would purchase products from the rest of the world rather than the region. It received no tariffs from the region, so there is no loss in tariff revenue, but consumer surplus increases by the area $P_{w2}P_{r2}CE$. Note that Uruguay gains by eliminating world tariffs regardless of whether it joins a free trade zone or a customs union. Compared to its original position (imports of Q_1 from the rest of the world and tariff revenues of Q_1t), eliminating world tariffs would reduce tariff revenue by $P_{w1}P_{w2}AD$ but increase consumer surplus by $P_{w1}P_{w2}AE$. This generate a net gain equal to the area ADE.

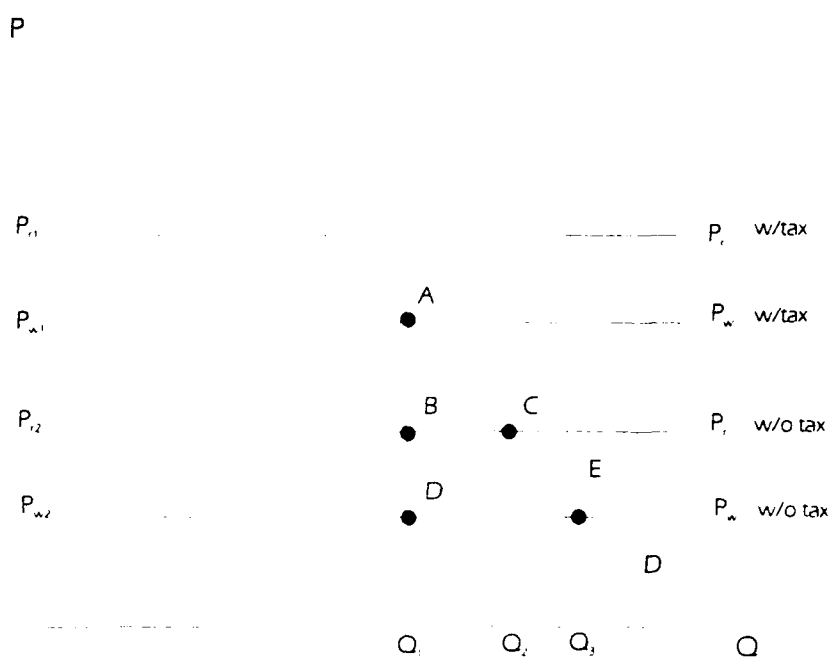


Figure 3. Tariff Revenue and Consumer Surplus: Regional Prices Higher than World Prices.

If regional prices are higher than the international prices plus tariffs, the net effect on Uruguay depends on how much world tariffs increase in a customs union. Suppose Uruguay enters a free trade zone and world tariffs are unaffected (Figure 4). Uruguay would continue to import Q_1 from the rest of the world and collect the initial tariff revenue (Q_1, t) . There would be no trade creation nor trade diversion. Reducing regional tariffs would have no effect. Note again that Uruguay gains by eliminating world tariffs. Tariff revenue would decrease by $P_{w1}P_{w2}AB$ but consumer surplus would increase by $P_{w1}P_{w2}AC$, producing a net gain of ABC .

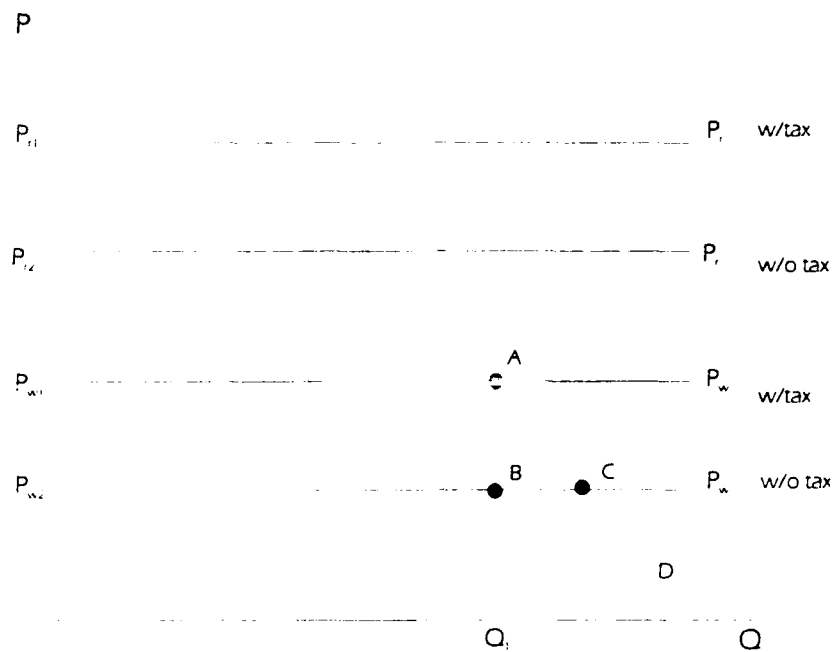


Figure 4. Tariff Revenue and Consumer Surplus: Regional Prices without Tariff Higher than World Prices with Tariff.

If Uruguay joins a customs union, the net effect on tariff revenues depends on the increase in Uruguay's external tariff. The world price plus increased external tariff could be lower or higher than the regional price without tariffs. In the first case (Figure 5), Uruguay would continue to import from the rest of the world, but imports would fall from Q_1 to Q_2 . Thus, the per unit tariff would increase, but it would be collected on fewer imports. Tariff revenues will change from $P_{w1}P_{w2}CE$ to $P_{w3}P_{w1}AD$. The net effect depends on the relative value of areas $P_{w3}P_{w1}AB$ and $BCDE$. Tariff revenues increase if

$P_{w3}P_{w1}AB$ is larger than $BCDE$, and vice versa. In either case, consumer surplus will decrease by area $P_{w3}P_{w1}AC$. Thus, there would be a net loss equal to area $ADEC$.

Uruguay would be better off if external tariffs did not increase.

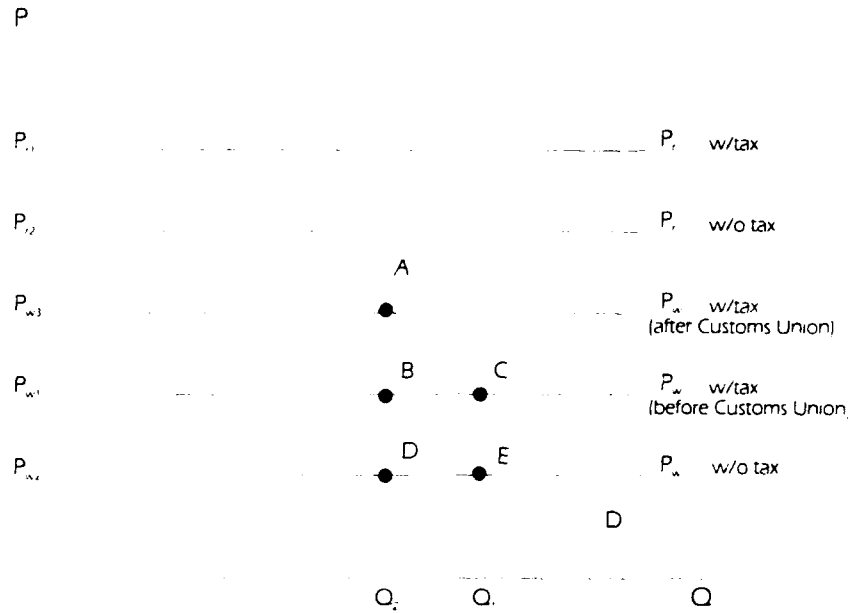


Figure 5. Tariff Revenue and Consumer Surplus: Regional Prices without Tariff Higher than World Prices with Customs Union Tariff.

In the second case (Figure 6), Uruguay would import Q_2 from the region. Not only would imports fall from Q_1 to Q_2 , but trade would be diverted from the more efficient world producers to the less efficient regional producers. There would be a

greater loss in this case: Uruguay would lose its tariff revenue (equal to area $P_{w1}P_{w2}CE$) and consumer surplus (equal to area $P_{r2}P_{w1}AC$).

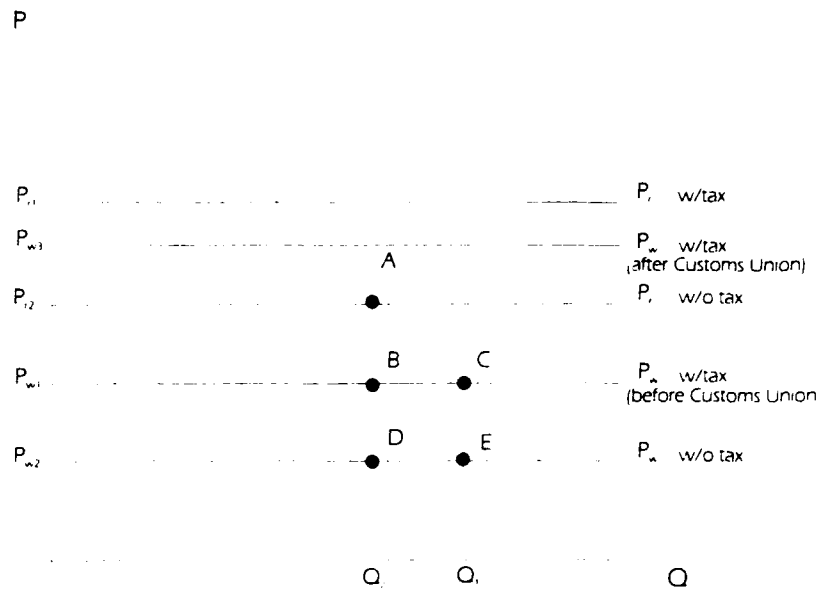


Figure 6. Tariff Revenue and Consumer Surplus: World Prices with Customs Union Tariff Higher than Regional Prices without Tariff.

Thus, joining the customs union would unequivocally decrease Uruguayan welfare. Uruguay's best strategy is again to eliminate external tariffs. As before, the loss in tariff revenue is more than offset by the gain in consumer surplus.

For a more realistic view, the analysis can discard the assumption that Uruguay either imports a good from the region or the rest of the world. Instead, Uruguay can be modeled as simultaneously importing a good from the region and the rest of the world (Figure 7).

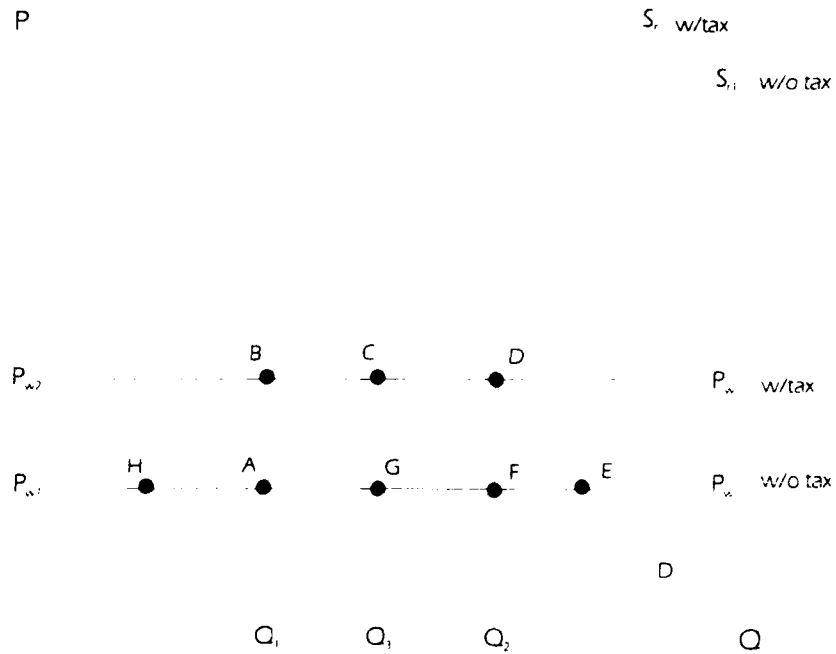


Figure 7. Tariff Revenue and Consumer Surplus: Uruguay Imports from the Region or the World.

Uruguay's demand curve for the product is D . S_r represents the region's supply curve with tariffs, and S_{r1} is regional supply without tariffs. Price P_{w1} represents the supply curve of the world's lowest-cost producer without tariffs. P_{w2} represents the world

price with the external tariff (assuming external and regional tariffs are equal). Before reducing regional tariffs, Uruguay imports Q_1 from the region and (Q_2-Q_1) from the rest of the world. Uruguay collects $P_{w1}P_{w2}DF$ in regional and world tariffs and production is efficiently distributed between world and regional producers (no lower cost world producers are displaced by higher cost regional producers if world and regional tariffs are equal). After reducing regional tariffs, Uruguay imports Q_3 from the region and (Q_2-Q_3) from the rest of the world. There will be both trade creation and diversion effects. Regional production increases but this increase displaces lower cost world producers. If the regional supply curve without tariffs intersects Uruguay's demand curve above the world price plus tariff, Uruguay will continue to buy from the rest of the world. In this case, reducing regional tariffs would not affect consumer surplus but Uruguay loses regional tariffs ($P_{w1}P_{w2}BA$) and part of its world tariffs ($ABCG$). These conclusions are applicable if Uruguay agrees to a free trade zone leaving external tariffs unaffected.

However, if Uruguay joins a customs union and external tariffs increase, the situation would be as illustrated in Figure 8. Uruguay's demand curve for the product is D ; the regional supply curve with tariffs is S_r ; the regional supply curve without tariffs is S_{r1} ; P_{w1} represents world price without tariff; P_{w2} represents world price plus the initial external tariff; and P_{w3} represents the world price with the increased external tariff. Before eliminating the regional tariff and forming the customs union, Uruguay imports Q_1 from the region and (Q_2-Q_1) from the rest of the world. Uruguay collects $P_{w1}P_{w2}BA$ in regional tariffs and $BAFD$ in external tariffs. With the customs union, Uruguay imports

Q_5 from the region and $(Q_4 - Q_5)$ from the rest of the world. After eliminating regional tariffs and increasing external tariffs, Uruguay loses all regional tariff revenue and external tariff revenue changes from BAFD to IMNJ. Compared to the free trade zone case analyzed above, Uruguay loses tariff revenue equivalent to area CKMG plus area LNDF, but gains area UKL. There would also be a loss in consumer surplus equivalent to area $P_{w3}P_{w2}JD$. Combined with the other areas representing losses in tariff revenue, this loss clearly exceeds UKL, the area representing a gain in tariff revenue. Uruguayan welfare would be reduced if it joins a customs union as opposed to a free trade zone. If the regional supply curve without tariffs intersects Uruguay's demand curve at a price below the world price with increased external tariff, Uruguay would only export from the region. In this case, Uruguay would lose all its external tariff revenue and some consumer surplus. Uruguay would be worse off in this case compared to a free trade zone. As before Uruguay's best strategy is to eliminate all regional and world tariffs.

It is clear that the free trade option would be better than the customs union due to the large increase in tariffs and the number of goods that would accede to Uruguayan market due to the new tariff level favored by the largest countries in the region. This reinforces views that a free trade zone is closer to unilateral openness. Neoclassical economic analysis implies that this is the optimal situation for a small country, such as Uruguay.

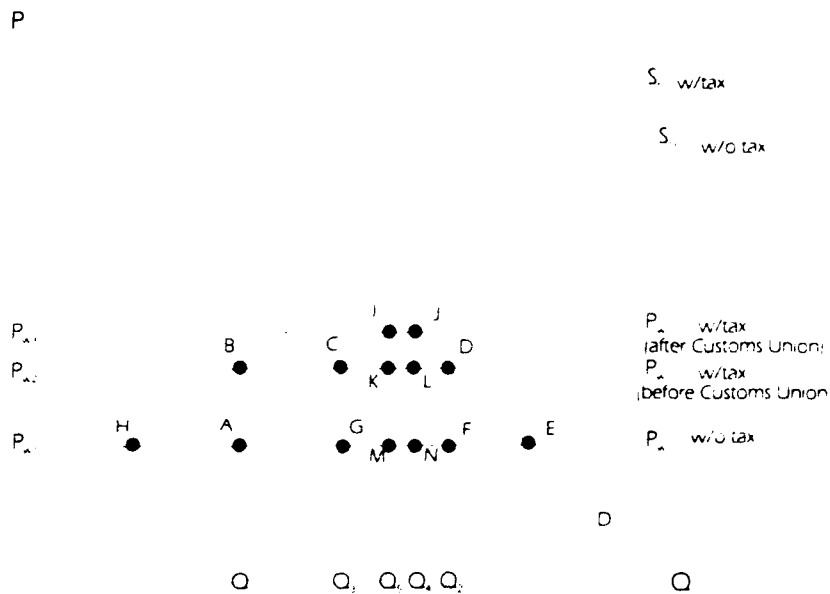


Figure 8. Tariff Revenue and Consumer Surplus: Uruguay Imports from the Region or the World and a Customs Union Tariff is in Place.

The previous analysis focused on changes in Uruguayan imports. One should also consider the possible beneficial effects that could occur if Uruguayan exports increase as a result of free access to protected regional markets. In the case of the customs union, these include goods that would receive more protection, such as textiles and food. The welfare effects for free trade zones and customs unions could be important compared with the option of non-participation. However, some expert observers believe that Argentina and Brazil would create a customs union even without Uruguay's

participation. If so, then Uruguay's exports would lose some access to Argentina's and Brazil's markets.

An argument against higher levels of integration is that economic instability can be transferred between participant countries. For example, a participant country experiencing economic instability can reduce exports and imports. This can influence the macroeconomic decisions of the other participants, in a way that can be seen as "exporting" instability to other participants. A customs union, which implies a higher level of integration than a free trade zone, would facilitate transferring instabilities from neighbor economies to Uruguay. This kind of phenomenon has occurred in the past: Argentinean and Brazilian instabilities have affected trade relationships with Uruguay. But the initial argument would lose validity considering that Uruguay's exports to the region are difficult to sell to the rest of the world. In other words, the regional exports are not substitutes for exports to the rest of the world. They are, generally, sales that would not be made to other markets.

2. The Perspective of the "New" Trade Theory

Manufacturing markets are characterized (to a different degree across particular products) by oligopolistic markets, economies of scale and product differentiation. International trade theory suggests that industrial policies in such cases can influence the direction of specialization.

Berretta (1991) points out that Uruguay received preferential access from its neighbors in return for importing goods that it does not produce nor protect. While

Uruguay's output is insignificant relative to the output of some national enterprises in these markets, Uruguay could have derived some advantage from its small size: "a small and non aggressive competitor to whom the others do not wish to damage."⁸³ Berreta points out that the Uruguayan trade with the region is increasingly intra-industry. Intra-industry trade consists of simultaneous exports and imports of identical or similar products, i.e., a country's exports and imports belong to the same industrial category. In such a case, countries may specialize on specific subsectors. Oligopolistic firms in different countries can produce differentiated products, each capturing economies of scale. Countries then export and import similar products. This trade modality is also known as two-way trade. A strategy of intra-industry specialization would intensify Uruguay's relations with the region. Meanwhile, a strategy of inter-industry specialization, aligned with the comparative advantages, would tend to intensify Uruguay's trade with the rest of the world.

The advantages of the intra-industry specialization emanate, at least in part, from the fact that producers exploit economies of scale to reduce costs. Furthermore, it could be expected that the costs in this type of process are lower than in inter-industry trade because of the economies of scale.⁸⁴

A strategy of specializing in differentiated products, which would increase intra-industry trade, would be consistent with a customs union, as long as the integration

⁸³ Nora Berreta, *Las Ventajas de ser Pequeño: Apunte para una Política Comercial Estratégica Frente al MERCOSUR*, CINVE, 1991.

⁸⁴ The economies of scale, in small countries, could also be generated in inter-industry specialization.

process continues. It would also be consistent a free trade zone, as long as the MERCOSUR agreement is limited to internal tariff reductions. A free trade zone could also increase exports outside the region. The tariff preference that the MERCOSUR countries grant to Uruguay is the same, in either case. However the preference that Uruguay grants to the partner countries is altered because of the products exception list, a fact that could be important in the political negotiation.

Uruguay's size could facilitate its participation in a free trade zone. Uruguay's industries that use factor inputs imported from the rest of the world do not compete with important markets for the larger partners. Losing these Uruguayan markets, because of Uruguay's low external tariffs, would not be significant for other regional partners.

With intra-industry specialization, the principal advantage of the free trade zone would be increasing competitiveness of Uruguayan exports to the region by importing less expensive, superior quality capital goods and inputs. A relevant cost of this option would be limiting the free movement of goods by having to certify the country of origin.

It is impossible to determine whether a customs union or a free trade zone would be clearly better in terms of intra-industry specialization. Given the asymmetry with the larger partner countries, specially with Brazil, a strategy of this kind would require Uruguay to promote specific sectors to help them capture economies of scale.

3. Openness and Economic Growth

To further measure the beneficial effects and losses in terms of efficiency and social utility that different forms of openness provide Uruguay, it is important to

consider long run growth. In this regard, evaluating costs and benefits from trade creation and diversion is a short-run consideration. It considers only the effects on production from better allocating resources (implying an allocation that responds to relative factor endowments) along a constant returns to scale production function with diminishing returns in each one of the factors.

The neoclassical growth model, following the work of R. Solow in the 1950s, has been the hallmark of growth theories until fairly recently.⁸⁵ The assumptions in the Solow model are constant returns to scale, diminishing returns to each factor and exogenous technological progress. Per capita production increases by increasing the capital-labor ratio (or the labor-land ratio if the latter were the scarce factor), though the benefits decrease as capital increases due to diminishing marginal returns to capital. Growth would continue until the reallocation of resources is complete, generating a level of real output higher than the previous one. It would not be a permanent change in the growth rate. Permanent increases would be introduced exogenously through technical progress.

The model can be postulated using a Cobb-Douglas production function for simplicity, i.e.,

$$Y_t = A_t K_t^a L_t^{1-a} \quad (1)$$

⁸⁵ Solow, R., *Technical Change and the Aggregate Production Function*, *Review of Economics and Statistics*, 39, 1957, pp. 312-320.

This model provided a framework for the growth accounting literature's attempts to quantify the contribution to growth of each physical input and technological progress. Even with adjustments for the quality of inputs (education, age-sex, vintages, etc.), these studies suggest that physical inputs account for only 50-70 percent of the growth rate of output. In other words, taking log-differentials in Equation (2) and using a "~" for percentage changes

$$\tilde{Y}_t = \tilde{A}_t + a\tilde{K}_t + (1 - a)\tilde{L}_t \quad (2)$$

A large part of output growth is explained by the "residual" A_t . This residual is generally attributed to exogenous technological progress, the only factor that could generate non-declining rates of productivity growth, a stylized fact for industrial economies.

Dissatisfaction with the last result, together with the neoclassical model's failure to explain other important aspects of economic development (like the non-convergence of productivity levels and growth rates between developed and less-developed countries), stimulated new endogenous growth theories. This literature builds upon the neoclassical growth model by studying the implications of externalities, increasing returns, and endogenizing the choice of technology, human capital and labor supply. It has the interesting insight that economic policy could affect not only the level of output --as in the neoclassical model-- but also the rate of growth.

Following Romer (1987)⁸⁶ and Helpman (1988),⁸⁷ we can classify those models into two broad categories: those where the economies of scale are external and those where they are internal. Among the former, the model in Romer (1986a)⁸⁸ makes technological change endogenous by assuming that private investment in physical capital increases the private stock of productive knowledge but it also becomes available to other firms in the economy. The externality associated with this technological spillover could overcome the diminishing returns to investment and yield a production function of the form

$$Y_t = B_t K_t^b K_t^a L_t^{1-a} = B_t K_t^{a+b} L_t^{1-a} \quad (3)$$

where B_t is basic knowledge -- that grows at an exogenous exponential rate -- and $(a+b)$ is the output-capital elasticity -- which differs from the share of capital. When $(a+b)$ is greater than or equal to 1, the per capita output can grow with no bound; for a fixed labor force, the borderline case of $(a+b) = 1$ behaves like a model with linear production. Lucas (1988)⁸⁹ presents a model where private investment in human capital yields a similar externality and increasing returns to scale. Human capital grows with its own utilization and previous accumulation, in a case understood as "learning by doing." Suppose two countries produce two goods and the production of one good accumulates

⁸⁶ Romer, P. *Crazy Explanations for the Productivity Slowdown*, in S. Fischer ed., *NBER Macroeconomics Annual*, MIT Press, Cambridge, MA, 1987

⁸⁷ Helpman, E. *Growth, Technological Progress and Trade*. Austrian Economic Papers, 1988, 1 pp. 5-25.

⁸⁸ Romer, P. *Increasing Returns and Long-Run Growth*, *Journal of Political Economy*, 94, 1986, pp. 1002-1037

⁸⁹ Lucas, R.E. *On the Mechanics of Economic Development*, *Journal of Monetary Economics*, 22, 1988, pp. 3-42.

more human capital than the other (one is more technologically developed). In a closed economy, the private allocation of resources is suboptimum, because decision makers do not directly obtain the social externality created by investments in human capital. In an open economy, the world supply of goods technologically more advanced is the one that grows more rapidly and its relative price tends to diminish. However, the countries which produce goods of lower technology, would not accede, in a spontaneous way, to produce the more advanced.

The second group of models allows for the existence of fixed costs in the production of intermediate inputs (Romer: 1986b, 1987).⁹⁰ In equation (2) this can be represented by replacing K_i with

$$\int_0^n x(i)^a di , \quad (4)$$

where $x(i)$ are intermediate products.

Productivity in the final goods sector depends on the range or number n of intermediate products $x(i)$, a key factor in creating increasing returns --together with the fixed costs of its production. Grossman and Helpman (1989)⁹¹ explicitly model the introduction of new varieties of consumer goods, as a result of an explicit calculation of the fixed costs of R&D and the future monopoly profits. Even though these models

⁹⁰ Romer, P. *Increasing Returns, Specialization and External Economies: Growth as Described by Allyn Young*, Rochester Center for Economic Research, W.P. 64, 1986 and *Crazy Explanations for the Productivity Slowdown*, in S. Fischer ed., NBER Macroeconomics Annual, MIT Press, Cambridge, MA.

⁹¹ Grossman, G.M. and E. Helpman, *Comparative Advantage and Long-Run Growth*, NBER Working Paper number 2809, 1989; *Endogenous Product Cycles*, Foerder Institute of Economic Research, Working Paper number 10, 1989 and *Growth and Welfare in a Small Open Economy*, Foerder Institute of Economic Research, Working Paper number 15, 1989.

appear to be more relevant for developed countries, the same economic principles that guide innovation could be applied to the adoption or adaptation of technology by less developed countries.

These models suggest that some policies can affect growth (Easterly et al. 1990).⁹² For instance, policies that reduce incentives to invest in physical or human capital, or to innovate or imitate, tend to reduce growth. Rebelo (1987)⁹³ gives an interesting insight, suggesting that policies that alter the return of factors that can be produced without the use of fixed factors affect the growth rate whereas policies that alter the return of fixed factors have only level effects. A general theme is the possibility of a trade-off between the negative static effect of some distortionary policies and their positive growth effect. With respect to trade policy, the Grossman and Helpman models show that trade liberalization can accelerate technological progress by increasing the size of the market available to technology producers. It could also increase that growth rate of countries that imitate technology. If trade policy succeeds in diverting resources towards product innovation, it accelerates growth (but welfare results may be ambiguous); but it could also divert talented people into rent-seeking endeavors and slow down the pace of innovation/imitation. Krugman (1988),⁹⁴ shows how the positive static effect of removing tariffs could be overturned by specialization in slow-learning low external human capital sectors.

⁹² Easterly, W., R. King, R. Levine and S. Rebelo, *Do National Policies Affect Long-Run Growth? A Research Proposal*, The World Bank, 1990.

⁹³ Rebelo, S., *Long Run Policy Analysis and Long Run Growth*, University of Rochester, 1987.

⁹⁴ Krugman, P., *The Narrow Moving Band, the Dutch Disease, and the Competitive consequences of Mrs. Thatcher: Notes on Trade in the Presence of Dynamic Scale Economies*, *Journal of Development Economics*, 27, 1988, pp. 41-55.

Although conclusions cannot be deduced directly comparing free trade zones and customs unions for Uruguay, this theory can provide some useful insights. From the point of view of the region as a whole, the common external tariff should not be very low. If it were, it would favor regional specialization in sectors which are not human capital intensive and would therefore result in a small growth rate in the long run. Consequently, the tariff structure proposed by Brazil would be compatible with this criteria. If industrialization were homogenous internally in the region, the customs union option would be preferable.

Complete openness would be detrimental to Uruguay as well. Brazil has a manufacturing production base that would foster human capital accumulation. This would give Brazil an increasing advantage relative to Uruguay. Human capital would not accumulate as quickly in Uruguay's industry. If the elasticity of demand substitution between manufactured and agricultural goods is greater than one, the relative price of the latter would tend to increase, and Uruguay's purchasing power could not grow as quickly as Brazil's.

So, it would be in Uruguay's interest to preserve the possibility of promoting industrial and technical policies, capable of channeling resources toward the sectors that are human capital intensive. If chemicals, which Uruguay exports to the region, depend on imported inputs from outside the region, it is possible that the free trade zone would be beneficial. Thus, Uruguay requires a policy of selective protection that has to be determined in autonomous way. On the other hand, those policies would have to promote

specific human resources through government action, because private agents would not have sufficient incentives if they can not directly obtain the external benefits.

4. Foreign Investment and Technology

Qualified spokesmen for Argentina and Brazil⁹⁵ assert that MERCOSUR's objective should be to encourage investment and technological modernization processes. A customs union, and possibly a common market, could create conditions more favorable for exchanging ideas and realizing joint investment and technological cooperation.⁹⁶ If Uruguay opts for a free trade zone, its ability to capture these benefits could be reduced, at least the benefits involving its neighbor states.

The theory of internalization (also called transaction-cost theory) offers an explanation of why foreign investment may be a more effective way of exploiting foreign resources and markets than exporting or licensing. It is a theory, therefore, of the multinational enterprise, whose hallmark is international production. This theory postulates that markets can fail to allocate factor services and goods efficiently due to natural and government-induced externalities and the multinational enterprise is an institution that internalizes cross-national exchanges of factor services and goods (particularly intermediate products) through foreign direct investment (international production).

⁹⁵ See Peña, Felix, *O MERCOSUR e suas perspectivas*, in Seminario IRELA, Bruselas, 1991 and Resek, Francisco, *Una Política Comercial para los Nuevos Tiempos*, in Revista Conexión, December 1991.

⁹⁶ This topic was in the Argentinean-Brazilian protocols (through the generation of bi-national enterprises, for example) but it does not have the same formality in the MERCOSUR agreements.

Multinational enterprises are the relevant agent in generating and transferring technology around the world.⁹⁷ In that regard, Dunning's eclectic theory intends to identify the conditions favoring production internalization.⁹⁸ The firm has to have some unique assets (advantage of property); it has to be able to increase its output and sales (advantage of internalization) and it has to have specific local conditions, related to the characteristics of the receiving or emitting country. The three conditions vary according to the specific country, industry or enterprise. Market failure is most evident in the exchange of knowledge. Only some of a firm's knowledge can be legally protected; other knowledge must be protected through the firm's own efforts to prevent disclosure to outsiders. The most direct way to prevent disclosure and thereby earn a rent is for the firm to internalize its knowledge. Instead of selling (licensing) its knowledge to outsiders, the firm applies that knowledge only to production under its control.

Internalization theory explains horizontal foreign investment as a response to market failure in knowledge, but it also explains vertical integration as a replacement of inefficient external markets. Firm-specific knowledge and other assets lead to foreign direct investment whenever intrafirm transactions become less costly than external market transactions.

⁹⁷ The average annual growth rate of real direct foreign investment in the world over the period 1985-1990 was 34%, while the rates for exports and GNP were 13% and 12% respectively. While the growth is greater among the developed countries (specially among the European community countries), it is relevant for the integration process. (UN, 1992).

⁹⁸ Dunning, John, "Explaining outward direct investment of developing countries: in support of the eclectic theory of international production," in Kumar, K. and McLeod, M.: *Multinationals from Developing Countries*, Lexington Books, London, 1981.

The eclectic paradigm of foreign direct investment, associated with Dunning, helps explain cross-country differences in the pattern of international involvement by multinational enterprises. To Dunning, foreign direct investment is attributable not only to the firm's ability to internalize its advantage but also to the presence of a foreign country in which production brings unique benefits to the firm. Thus, both firm and country-specific endowments are necessary for foreign involvement. When it is most profitable for a multinational enterprise to internalize its monopolistic advantage in a foreign country, then the multinational enterprise favors investment in that country. Otherwise, it exploits the country market through export or licensing.

Dunning identifies an empirical foreign investment-development cycle, that can be explained in the following way: as the industrialization process advances, the variables that determine the advantages of localization and property are modified. This promotes growth in some firms, so they began to internalize production through direct foreign investment. From this point of view, Brazil and Argentina would currently be expanding their foreign investment.

Direct foreign investment of the Latin-American firms has been concentrated in the region. This can be explained by the different levels of development among the countries (White, 1981).⁹⁹ The property advantage would be generated by learning and adapting technology to the local conditions. This would make it easier for Latin

⁹⁹ White, Eduardo, *The International Projection of Firms from Latin American Countries*, in Kumar, K y McLeod, M eds: *Multinationals from developing countries*, Lexington Books, London, 1981.

American firms to transfer and develop technology in less developed technological countries but with similar market size, factor availability and prices, etc..

Because Argentina and Brazil are deregulating and promoting foreign direct investment (for example by converting their external debt), Uruguay could capture certain localization advantages if it opts for a free trade zone. These advantages could offset its size disadvantages for its internal market. The regional or extra-regional multinational firms could better import capital goods and inputs in Uruguay than in the partner countries. They also could access Argentinean and Brazilian markets, provided they can satisfy the requisites of origin for those exports.

It is possible that the partner countries, while perhaps accepting Uruguay as a free trade zone, would not allow Uruguay to benefit from other forms of integration. In the short run, the cost to transship across borders would be increased. The difficulty of proving the country of origin would introduce certain subjectivity to Uruguay's exports. This would be added to the very problematic total elimination of non-tariff barriers, and thus would reduce Uruguay's localization advantage in investments aimed at regional exports, adding uncertainty regarding access to those markets.

VI. CONCLUSIONS AND RECOMMENDATIONS

Throughout modern economic history, governments have oscillated between protectionism and free trade in an effort to alternatively develop increased production capabilities and the markets to absorb the goods generated by such expansion. The private sector, as well, has learned to take maximum advantage of existing and contemplated trade policies to locate production and marketing enterprises across national boundaries in an effort to reduce production costs and enhance sales revenues.

Today, however, it seems that the distinction between clearly protectionist and clearly free trade policies is blurring. Governments are being pressured to open markets to foreign competition and preserve the interests of national industry at the same time. While trade barriers have been reduced through multilateral agreements since the end of World War II, the recent emphasis has demanded more access for investment and more international control of domestic policies to ensure fair market competition.

In the global atmosphere of economic change, Uruguay, like many other countries, finds itself involved in global trade talks and regional negotiations. Uruguay's small size, combined with the slow progress of the GATT talks, contributed to the government's positive reaction to being invited to participate in a regional trade agreement with Argentina, Brazil, and Paraguay, its closest neighbors. Regardless of the intent with which Uruguay arrived at the MERCOSUR bargaining table, the fact remains that it is

facing the consequences of initial treaty obligations, as well as the consequences of continuing the process of further economic integration, as outlined by the agreement.

As noted in Chapter I, the goal of this research effort was to ascertain the effects of the impending MERCOSUR customs union on Uruguay, in light of the economic and trade backgrounds of the participants and the global tendency toward regionalization. The following sections discuss the relevant conclusions, offer recommendations as to Uruguay's most beneficial course of action, and suggest areas for future research.

A. ECONOMIC REGIONALIZATION

As discussed in Chapter II, there is an ongoing international trend toward economic integration on a regional level. This trend originates from the desire of nations to develop more global trading regimes. Global trading regimes are capable of redistributing income among productive factors within each country, accelerating overall technological development, and accelerating the diffusion of technology from innovating countries to less-developed ones. From the standpoint of developed nations, multilateral trade offers the opportunity for developing new markets and the demand for further technological innovation. For under-developed nations, the reciprocal benefit is the development of their economies and the expansion of their technological base. Such motivations were instrumental in first bringing together the participants in negotiations for the General Agreement on Tariffs and Trade.

In spite of the push for global openness, however, the observed phenomenon in international trade has been the development of regional trade agreements. The motives behind this proliferation of regional agreements are complex, and include:

- The belief that regional integration is conducive to growth
- Disillusionment with the framework for global integration
- A perceived need to take defensive action as other countries form or reinforce other trading blocs

The first of these factors, that regional integration is conducive to economic growth, is a logical extension of the reasoning by which nations have come to the GATT talks. The frustration experienced in these international negotiations provides the basis for the second factor, as nations turn to more familiar and geographically proximate partners with which to achieve economic development. The third factor is also a reaction that must be expected, given the rapidity and extent of economic integration in certain areas of the world. With the current level of progress in the GATT talks, nations with limited economic bargaining power view the European Community and free-trade agreements such as NAFTA with increasing anxiety, fearing that the lack of international progress leaves them no choice but to seek regional solutions to trade and development problems or fall by the wayside, as a few very powerful bloc realign the global economy to their own benefit.

B. THE MERCOSUR AGREEMENT

Chapter III outlined the provisions of the MERCOSUR agreement, and detailed the treaty's progress and issues that have arisen as the participants have implemented the treaty's provisions. The treaty's provisions are:

- Establishing the free circulation of goods, services, and production factors
- Unifying customs procedures
- Establishing a common external tariff for trade with the rest of the world
- Coordinating macroeconomic policies

As noted in Chapter III, implementing the agreement is proceeding as scheduled, but it is unclear whether the participants will be able to negotiate a mutually acceptable procedure for implementing the common external tariff at the end of 1994.

Uruguay's involvement in the MERCOSUR agreement is initially defined by three key points:

- Uruguay's economy is dwarfed by those of the two large MERCOSUR participants, Argentina and Brazil
- The majority of Uruguay's trade is with these two large countries
- MERCOSUR itself began as an agreement between Argentina and Brazil

With these three factors setting the stage for Uruguayan participation in MERCOSUR, it might be assumed that the only option for the country would be to continue the process of economic integration established by MERCOSUR and make the best of the resulting trade situation. The objective of this research, however, called for a

more detailed investigation of the trade situation among the treaty participants, including their individual economic profiles, in order to make a more accurate prediction of the outcome of treaty provisions.

In Chapter IV, the various economic conditions and indicators of each treaty participant are discussed in detail. As a cursory examination of the region might lead one to expect substantial economic disparities between the two larger participants (Argentina and Brazil) and the smaller countries (Uruguay and Paraguay). The differences that have the most impact in terms of MERCOSUR are concentrated in the following areas:

- ♦ Cost, scale, and diversification of production
- ♦ Level of technology
- ♦ Size of the markets
- ♦ General level of economic and social development
- ♦ Differing natural resources
- ♦ Level of inflation
- ♦ Different historical trade policies regarding protectionism and openness

Brazil is the most important MERCOSUR participant in terms of its ability to sell industrial products to non-industrialized nations. This capability was developed through a policy of protectionism that only began softening in the late 1980s. Brazil's proposed tariff structure for the end of 1994, intended to continue liberalization, actually continues protectionist policies. This is clearly evident in the trade categories of capital goods and transportation equipment.

In Argentina and Uruguay, the trend toward liberalization began in the early 1980s, and involved trade economies that focused on natural resources and agricultural products. While trade patterns between Argentina and Uruguay involve similar goods (i.e., intra-industry trade), the patterns between Brazil and Uruguay are similar to those between Uruguay and the rest of the world, involving different types of goods (i.e., inter-industry trade).

These differences have contributed to the difficulties that have been encountered in implementing the treaty, as well as to the general problem of harmonizing the four economies involved. Moreover, resolving the interests that arise as a result of these individual differences involves a lengthy negotiation process.

Time to resolve differences, however, is a luxury that the MERCOSUR participants do not have. In sharp contrast to the lengthy development of conditions that allowed the economic integration of the European Community, the MERCOSUR schedule of implementation calls for rapid integration. While the common external tariff was to be established by the end of 1994, ongoing disputes over the tariff rate that will be applied to non-MERCOSUR trading partners have led some to anticipate that MERCOSUR will, for the present, remain a free trade agreement, rather than becoming the customs union envisioned by the treaty's provision for a common external tariff.

C. URUGUAY IN MERCOSUR

It was, in fact, the Uruguayan President who first voiced the opinion that a common external tariff might be out of the immediate reach of the MERCOSUR countries. For Uruguay, in spite of the extreme inclination to move forward with its neighbors and primary trade partners, the common external tariff has significant implications for Uruguayan welfare.

The two possibilities, free trade zone or customs union, provide a vehicle for researching the impact of the MERCOSUR agreement on Uruguay. The research can predict the effects of each option on foreign direct investment, economic development, and the general welfare of the country. The methodology employed was to contrast the effects of a free trade zone and a customs union using traditional and new theories of international trade. While the traditional theory assumes perfect competition, the new theory considers market failures. The analysis also considered that Brazil's relative size and economic power would lead to a MERCOSUR common external tariff that reflected the individual structure that Brazil has targeted for 1994. Therefore, the analysis assumes these common external tariff rates.

For Uruguay, a free trade zone is preferable to a customs union. A free trade zone would reduce the cost of trade diversion. In other words, it would reduce the transfer of revenue toward inefficient producers in the region. The welfare of Uruguay, measured by tariff revenue and surplus value, would increase. If the agreement implements a customs union, the losses would involve those products that Uruguay would begin to import from

the region, instead of from the rest of the world. This is due to the fact that the common external tariff would be higher than the Uruguayan external tariff in a free trade zone. Uruguay would lose tariff revenues currently realized from importing goods from the rest of the world if the customs union option is implemented.

Additionally, in a free trade zone, Uruguay would be able to take advantage of the world-wide competitive market for goods. This capacity for procuring superior products at reduced prices would enhance Uruguay's position as an exporter as well, and would favor a strategy of intra-industry product specialization. This opportunity for growth would be sacrificed in a customs union. Additionally, a free trade zone could attract foreign direct investment from outside the region.

The existence of a free trade zone for Uruguay might also have effects beyond the current MERCOSUR membership. When Chile declined to participate in MERCOSUR in August 1990, its representatives stressed that, while they were interested in establishing a free trade agreement, Chile had no desire to participate in a common market. One of the difficulties that Chile has with a common market arrangement concerns a common macroeconomic policy. This concern goes beyond the future expansion of the agreement to other countries, however. There are already concerns about the effects of common macroeconomic policies among MERCOSUR participants, due to the instability present in some participant's economies.

However, pursuing the free trade option might result in greater cost than a customs union in two areas. First, intra-industry product specialization could be hampered due to

rules regarding country of origin. Second, Uruguay's ability to attract direct foreign investment might be limited in the case of goods destined for the two larger MERCOSUR participants, if those participants restrict these categories of goods.

While this decision is, in some measure, unilaterally Uruguay's, with ramifications for the other MERCOSUR participants, it may be that the Uruguay's relatively small size might encourage the other members to allow Uruguay to maintain a free trade zone with MERCOSUR, rather than adopt the common external tariff. Relative size has been instrumental in the past in obtaining special concessions for Uruguay in trade agreements with Argentina and Brazil.

D. RECOMMENDATIONS REGARDING URUGUAYAN PARTICIPATION

Due to the relative costs and benefits associated with free trade zones and customs unions, it appears that Uruguay should attempt to maintain free trade zone status with the other MERCOSUR nations. The government's ability to negotiate such an agreement is enhanced by Uruguay's history of special arrangements with Argentina and Brazil. This preferential treatment has been justified before on the grounds of Uruguay's relative economic size. The prospects for success in MERCOSUR are at least fair.

If such an accommodation cannot be reached, however, Uruguay will have to negotiate provisions that will mitigate at least some of the costs of entering a customs union with the other MERCOSUR participants. Such provisions should aim to establish a common external tariff for goods that will not negatively impact Uruguay's trade

situation. Goods which are deemed critically sensitive to the impact of a common external tariff should be excluded from this initial list. The agreement might gradually include these items, as the protectionist tariff levels employed by the common external tariff are gradually reduced. This reduction would be the expected course if Brazil maintains its dominant industrial position and liberalizes its trade policy.

E. RECOMMENDATIONS FOR FURTHER RESEARCH

This analysis was based on the tariff structure proposed by Brazil, and considers groups of products. Further analysis might seek to break these groups, such as "capital goods", into more specific divisions to determine whether using average group rates influenced the results. Future research might also investigate the effects of transnational expansion on the relationships among various regional enterprises.

APPENDIX. MERCOSUR TIMELINE

1985	
November	Declaration of Iguazu Start of the Integration Process between Argentina and Brazil
1986	
July	Declaration of Integration Argentina and Brazil signed 24 Protocols and Uruguay is invited to participate in the integration process
1988	
April	Acta de Alvorada Formally marked Uruguay's incorporation into the agreement
November	Integration Treaty Bilateral treaty signed by Argentina and Brazil
1990	
July	Common Market Group
August	Chile and Paraguay are invited to participate Chile refuses, Paraguay accepts
1991	
March	Treaty of Asunción Set up of the Common Market of the Southern Cone (MERCOSUR)
June	Rose Garden Agreement Set a framework to discuss relaxing trade barriers between the United States and MERCOSUR members
December	Brasilia Summit Meeting The four presidents ratified the internal regulations of the MERCOSUR Group and an arbitration system for resolving disputes among members.
1992	
July	Las Leñas, Mendoza, Summit Meeting The presidents approved a complete and meticulous timetable for achieving integration by January, 1995
December	Montevideo Meeting External Tariffs would range between 0 and 20%, with a small list of exceptions to be protected by a 35% tariff
1994	
January	There were still disagreements over the common external tariffs

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