CPA FERRERE

Introduction to Mercosur: Challenges of Growth and Business Opportunities

Prepared for the launch of IBBA

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Content

Executive Summary

i. In the framework of the launch of the Bering Bellinghaussen Institute for the Americas (BBIA), this report describes some of the economic characteristics of the Southern Common Market (Mercosur) and analyzes the main strengths and challenges that it faces. The aim of this report is to identify the possible areas of economic complementarity between Russia and Mercosur, as well as Uruguay's role in the process.

ii. Mercosur was created in 1991 as a customs union between Argentina, Brazil, Paraguay and Uruguay with the following objectives: i) encourage an international integrated economic insertion among the countries of the bloc, ii) promote free circulation of goods, services and production factors, iii) coordinate macroeconomic and sectoral policies, and iv) harmonize the legislation of the member countries. It is currently composed by five full members, which are Argentina, Brazil, Paraguay, Uruguay and Venezuela; there are also associated states: Chile, Bolivia, Colombia, Ecuator, Peru, Guyana and Suriname.

iii. Mercosur's five full members comprise 277 million residents, accounting for 4.3% of the global GDP and a total GDP per capita of USD 13,260. The five countries display asymmetries in size and resource endowment. Brazil represents the main economy of the region; its GDP is five-fold Argentina's (the second economy) and has a decisive role in the region's economy.

iv. Mercosur has not reached the objectives that were proposed initially. The lack of a solid institutionalism lead to an imperfect functioning of Mercosur's Customs Union. Lately, the lack of progress in commercial negotiations with other blocs, the countless violations of the Common External Tariff (CET), as well as the protectionist measures in behalf of Brazil and especially Argentina, lead to an even more fragile process of economic integration. In this manner, Venezuela's inclusion in 2012, did not result –as some governments were hoping to- in the re-launching of the Southern Common Market project.

v. An outcome of this economic integration during the last 25 years was a greater synchrony between Brazil's economic cycles and smaller economies of the bloc such as Paraguay and Uruguay –although this is true for Argentina as well-. As a result of this, the current external risks that these four full members face are more strongly correlated nowadays than in the past.

vi. During the last decade, the very favorable international scenario made Mercosur's economies more dynamic. Said scenario was characterized by a firm and sustained demand for agriculture and livestock production encouraged by China's and India's

growth, one of the financial (high liquidity and low interest rates) and a low exchange rate with relation to the American dollar (international currency of reference for the region). Because of this, economic growth in Argentina (6.6%), Brazil (3.7%), Paraguay (4.8%) and Uruguay (5.6%) has surpassed the average values reported for the latter half of the last century.

vii. The production of raw materials, specifically food products, is one the driving forces of the region, especially in Argentina, Paraguay, Uruguay and some regions of Brazil. Under different schemes and with different intensities in different periods, said specialization has encouraged and promoted industrialization, as well as the development of service provision. As a consequence of this, the region is one of the main producers and exporters of food products at a global levels. Particularly, exports in the Mercosur represent 56% of global soybean trade, 40% of global maize trade and 20% of global bovine beef trade.

viii. Nowadays, China is Mercosur's main commercial partner, accounting for 15-20% of the total extra-bloc exports and imports, mainly in the food sector and an important participation of Chinese capital goods.

ix. Currently, trade between Mercosur and Russia is not significant since it represents 1.8% of Mercosur's global trade (Russia is ranked as main commercial partner #12). On the other hand, Mercosur represents 1% of Russia's global trade (Mercosur is ranked as main commercial partner #24). Almost all exports from Mercosur to Russia are food products (frozen beef, sugar and soybean), and all imports are comprised by fossil fuels and mineral fertilizers.

x. Because the countries of the region export agriculture and livestock products and they rely heavily in foreign trade as a connection to the rest of the world the logistic sector has been under pressure in the last decade. The development of global trade and a favorable panorama of the countries that export food products will very possibly lead to a growing demand for logistic services in the region.

xi. The Global Competitiveness Index formulated in the World Economic Forum shows that all the countries of Mercosur have fallen behind in terms of communication infrastructure development. Because of this, investments in road, railway and port development has been one of the main challenges of the bloc. Consequently, during the next decade, the agenda of the countries of the region will be centered on these items.

xii. Traditionally, the funding of infrastructure works has been conducted by public loans or by loans from multilateral credit agencies such as the World Bank (WB), Inter-American Development Bank (IADB) and more recently the Andean Development Corporation (ADC). Private financing has had a less relevant role, with the exception of the cases of larger economies such as Brazil and Mexico, or with a larger development

of their capital markets in the case of Chile and Colombia. Lately, the China Development Bank (CDB) and the Export-Import Bank of China (China Ex-Im Bank) have increased its presence in the region. Chinese banks have focused mainly in financing infrastructure works in countries that have less access to international markets.

xiii. The magnitude of the projects to be funded in the region, the levels of associated risks and low liquidity from international financial markets in the upcoming years have given place to speculation in regard to opportunities that financial entities may have in the future and have not had until now.

xiv. Like the other countries in Mercosur, because of its production characteristics and the levels of investments in infrastructure, Uruguay is presented as an attractive destination for investments. The increase in exports in the last decade, driven mainly by agriculture and livestock production such as soybean, bovine beef and cellulose pulp have generated a high demand in the logistic sector generating investment opportunities in road, railway and port infrastructure.

xv. Besides being an attractive destination because of the previously mentioned reasons, there are also institutional characteristics and the fact the Uruguay has traditionally been a friendly country in relation to foreign investment that make Uruguay an excellent platform for business development in the region. Some of the competitive advantages that Uruguay offers are:

Political stability: In the last 20 years, the three most important political parties have peacefully alternated in government. Additionally, the institutional regime does not allow the rise of outsiders in the political system.
Economic predictability: The last decade had an average growth of 5.6% and policies that are heavily committed with macroeconomic stability, that respect the business climate, guarantee free flow of capitals and promote local and foreign investment have been implemented.
Legal certainty: A stable institutional framework with a deep respect for contracts and property rights. Uruguay is internationally recognized for its low level of corruption and its effect in the operations of private businesses.
Strategic location: Close to the main centers of activity of Mercosur, Uruguay has positioned itself not only as a logistics hub for imports coming to the region but also as the main gateway of agriculture and livestock production from the region to the rest of the world.
Special schemes for investment promotion:

Free Trade Zone law: Isolated areas inside the national territory that have tax exemptions and are granted benefits, with the objective of undertaking any kind of industrial commercial or service activities.

Free Port: Allows the transfer of imported and exported goods without any formal proceedings, favoring the upstream transfer of goods to Paraguay, eastern Argentina, southern Brazil and northern Uruguay.

Tax incentives on investments: Encourages the development of productive investments in the country, providing tax benefits that allow local and foreign investor to be exempt of up to 100% of the taxes on their investment.

Public-Private Participation (PPP): Procurement system between a Public Administration and the private sector where the contracting party hires the contractor to design, build and/or operate the infrastructure.

xvi. In recent years, Uruguay's financial system has been displaying high stability, solvency and liquidity, in spite of the fact that profitability levels have been low. As a result, the Uruguayan banking system is undergoing transformations characterized by a larger focus on fewer businesses and consolidation of agents with greater presence and regional expertise. This reality, coupled with financing needs for the development of infrastructure at a regional level and the favorable regional business conditions in Uruguay, could give rise to new opportunities for new institutions that seek to channel savings into the real economic sector providing funding for infrastructure investments for Mercosur countries.

I. Introduction

The change in the international economic landscape in recent decades has given a greater role to emerging economies, particularly the Asian bloc and to a lesser extent the South American bloc. The dynamism of these economies both in domestic and foreign markets suggests that there still significant opportunities for commercial and financial exchanges between the economies of South America and Asia.

In the last decade, Mercosur has closely experienced these changes with Asia's economic thrive, mainly led by China as one of the main driving forces in the region in economic terms. This link has generated major changes not only in terms of business models, but also in the mindset of the business sector in the region, which has expanded its horizons and has come to take an active role in global business brands

As part of the launch of the Bering Bellinghaussen Institute for the Americas (BBIA) -an institution created with the goal of promoting and booting economic and cultural exchanges between the Customs Union comprised by Russia, Belorussia and Kazakhstan with South America- this report aims to outline some of the main characteristics of the region, emphasizing on the strengths and challenges with the objective of identifying possible complementarity opportunities between Russia and the Southern Common Market.

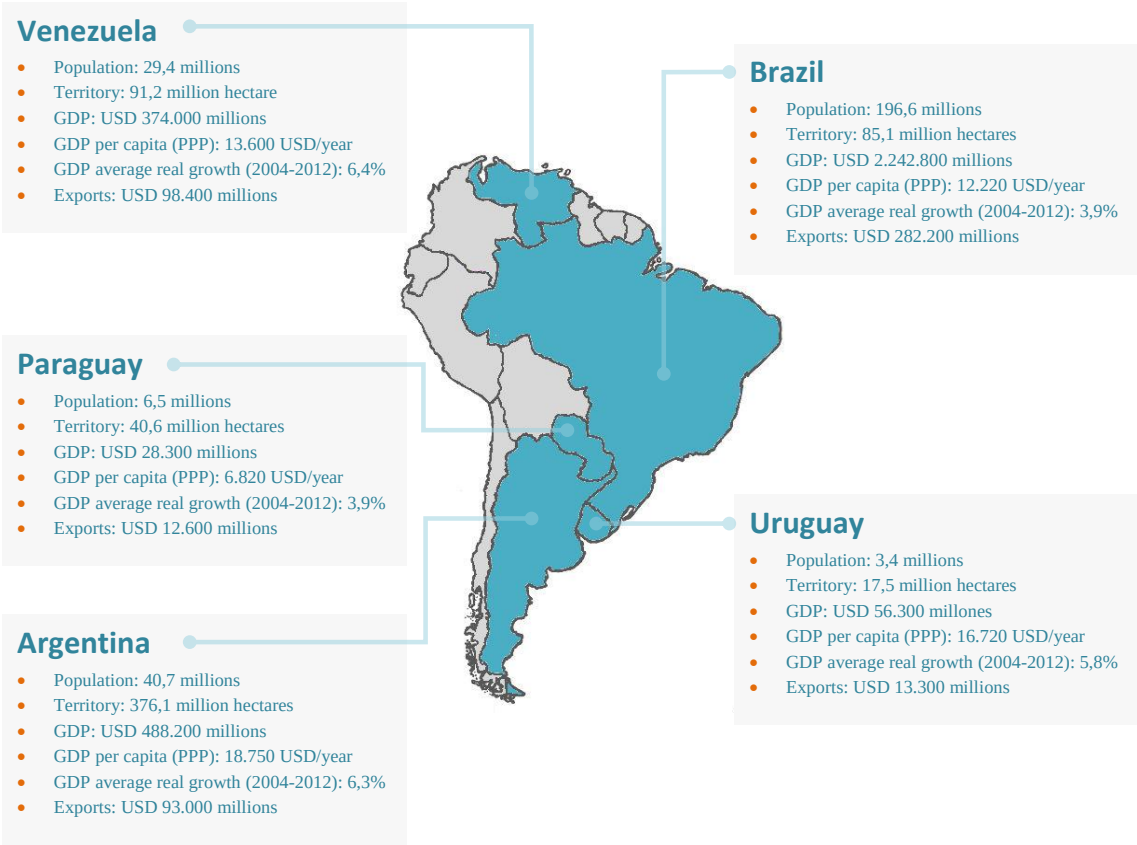
In this manner, the document is organized as follows: The following chapter offers an **Analysis of Mercosur**, with a brief introduction to its origins and the characteristics of the countries that compose it, a panorama of the main macroeconomic factors that affect the region, a description of the economic structure, trade characteristics of each country and finally a description of the financial system of the region. The next chapter will include a **Description of the main challenges and constraints to economic development of the bloc**, an analysis of the demands of the logistic sector in recent years, the difficulties imposed on the infrastructure deficit in the region and a brief description of the entities involved in the financing of these infrastructure works in the region. Finally, the last chapter suggests **Uruguay as a regional business platform,** it identifies some of the main features and competitive advantages of Uruguay for the installation of regional businesses.

II. Mercosur Analysis

Since its creation in 1991, the Southern Common Market was positioned as one of the most relevant trade blocs in Latin America. It started with the incorporation of Argentina, Brazil, Paraguay and Uruguay, which accounted for over 50% of Latin America's GDP and was projected as a pathway toward the integration of the entire continent.

Although a customs union was created initially, using the Common External Tariff (CET) as a pillar of this union, it currently operated with certain rigidities in terms of customs and tariffs. The bloc has not been limited to treating economic and trade issues, but instead has tried to explore the integration of the member states in other areas such as education and environmental protection. The bloc currently consists of five full members (Argentina, Brazil, Uruguay, Paraguay and Venezuela) and several associated countries.

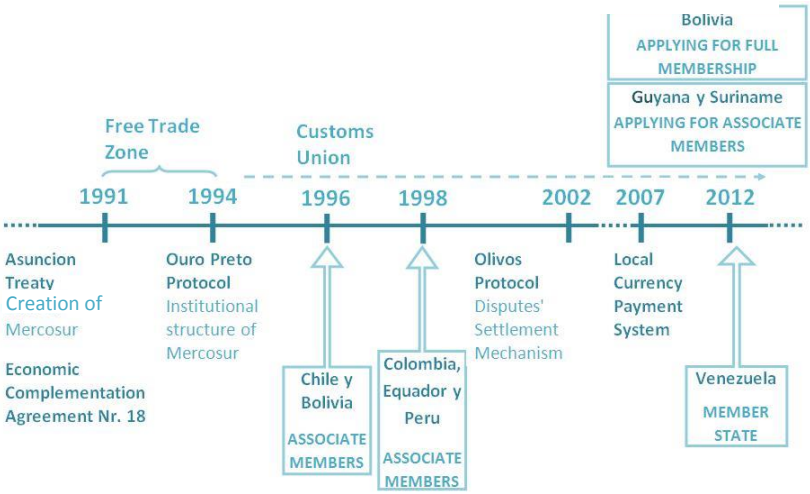
Illustration 1 – MERCOSUR at a glance (Main indicators)



II.1 Creation of Mercosur

In March 26th, 1991, as from the signing of the Asunción Treaty, the Southern Common Market (Mercosur) was created. Its signatories were the Republic of Argentina, the Federative Republic of Brazil, the Republic of Paraguay and the Eastern Republic of Uruguay (from this moment on, the State Parties). In this "Framework-Agreement", the proposed objectives were: **i)** the establishment of a common external tariff, **ii)** free movement of goods, services and factors of production **iii)** coordination of macroeconomic and sectoral policies, and **iv)** harmonization of the legislation.

Illustration 2 – Milestones in the history of MERCOSUR



After its creation, Chile and Bolivia were included as Associated States in 1996, all the members of the Andean Community of Nations (Colombia, Equador and Peru) were included are Associated States in 1998 and Guyana and Suriname in 2013 (still in process), this way all the countries in the South American continent participate in the Mercosur bloc. Additionally, New Zealand and Mexico are Observer states.

In 2012, Venezuela was included as a Full Member of the Mercosur bloc and Bolivia is now in the process of becoming a Full Member. Both incorporations represent an increase in the trade opportunities of the intra-bloc, in addition to the high energy potential of both countries which represents an increase in the energy reserves of Mercosur.

In this manner, the trade bloc was formed with a significant asymmetry among its members. This asymmetry is mostly generated by the structural differences between the countries in relation to size and endowment factors, with Brazil as its indisputable leader (its economy is 100 times superior to Paraguay's, 45 times superior to Uruguay's and 5 times superior to Argentina's) and the rest of the countries as followers, in addition to the significant divergences in policies sovereign regulations – such as tax policies, industrial policies and macroeconomic administration.

These asymmetries are not only important with regard to the convergence of per capita income in the long term, but also to create incentives for integration in the case of smaller

partners, and can be either slowed down or strengthened by the adopted macroeconomic policies. Among them, exchange monetary policy, promotion policies and fiscal policy play a fundamental role.

In this regard, monetary integration among member countries is stagnant. Despite some attempts to form a monetary union in the region, each member retains its own currency and monetary policy autonomy. The last attempt was the creation of the Payment System in Local Currencies (PSLC) [1]. While this policy is a step forward, only Argentina and Brazil have used this system to trade.

This deterioration of the integration process began shortly after the creation of Mercosur. In the late 1990s, Argentina and Brazil, the most influential economies in the bloc, adopted flexible exchange rate systems and devalued their currencies. This practice undermined the confidence in the integration process and led to the implementation of some protectionist measures that eroded the credibility of the integration process of the bloc[2].

More recently, at least since 2009, the Mercosur agenda is not only stagnant, but even major setbacks are recorded on integration. In late 2011, Argentina and Brazil began to implement intra-bloc trade restrictive measures and with this the aspiration of a free trade oriented Mercosur has been diluted, resulting in a shift to bilateral negotiations between countries.

Structural differences between member countries, coupled with a lean institutionalism and lack of transversal policies between countries have prevented Mercosur to reach the objectives proposed initially.

[1] Annex V.3.iii)
[2] Medina Moral, 2004.

II.2 Macroeconomic Panorama of the Region.[3]

Naturally, the constant attempts to integrate the countries of the region through the years have led to an increase in the levels of economic interdependence.

A central feature of macroeconomic interdependence derived from the Mercosur integration process is the high correlation of the shocks that the economies of the member states have faced, both originating in the rest of the world as those arising from any of the countries of the bloc[4]. In this context, it is vital to develop a comprehensive macro-economic overview of the region and understand that it is not possible to analyze the economic performance of a country disregarding the performance of the other partners in the region. This approach is particularly relevant when analyzing the smaller countries of the region, which depend largely on the economic performance of Argentina and Brazil.

In this sense, in the next section the general macroeconomic outlook of the economic bloc will be briefly analyzed in order to analyze the macroeconomic panorama of Argentina and Brazil, as the main economic players in the region's economic performance and finally a brief analysis of Uruguay's macroeconomic outlook will be presented.

Macroeconomic Environment and Perspectives of the Region.

In the last three years, symptoms of recovery have been observed in the United States (and to a lesser extent in some European countries), because of said symptoms the Federal Reserve has started to change its monetary policy, which from 2008 until now has sought to revive the economy with an aggressive monetary expansion. As a result, the dollar began to strengthen, interest rates surged and the financial boost that *commodities* have received in recent years has begun to fade.

In this context, once the United States strengthens its recovery process and makes progress on changing its monetary scaffolding, the era of the cheap dollar, exceptionally low rates and high liquidity that characterized the post-2008 international scenario will end. As a result, the economies of the region will have significant challenges ahead in macroeconomic terms because the international scene will not be as favorable as it has been in recent years.

In particular, it is expected that in this new context, *commodity* prices start to be more connected to real motives (demand, weather conditions, balance stocks) rather than financial motives, while capital flows toward emerging economies could start to decrease as a result of the global interest rate levels. Consequently, a less favorable outlook with relation to raw material prices may be foreseen, and because of this, funding for the real sector of the economy may be difficult to obtain. This may represent an addition restriction for the external sector.

[3] Annex 3
[4] Fanelli y González Rozada, 2006

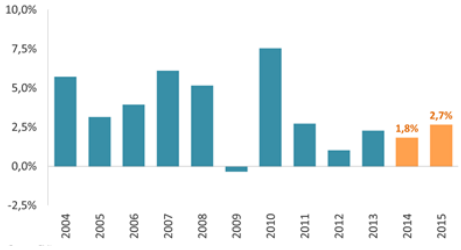
Macro Scenario for Each Country.

Brazil: moderate growth and less margin for action

Despite Brazilian economic activity reached a higher growth in 2013 than in 2012 (2.3% and 0.9% respectively), the prospects for growth in the coming years remain moderate. In this sense, the latest survey pointed out that the Brazilian Central Bank foresees an expected growth of 1.2% and 1.7% for the two coming years. These low growth prospects could be linked to private sector investment stagnation, coupled with a limitation in the rate of household expenditure by higher consumer indebtedness and a progressive deterioration of the fundamentals of consumption (employment and income).

While macroeconomic management has restored the balance and the improvement of the external position has reduced vulnerabilities and ruled out the risk of a Balance of Payments crisis in the short and medium term, Brazil has yet to face significant economic policy challenges to channel growth in the long run. Particularly, Brazil has to implement an agenda of structural reforms in order to increase productivity and make the infrastructure *shock* more feasible in order to take a leap in physical capital stock. The main restrictions for the future are associated with the low level of domestic savings and the current scenario of scarce external financing.

Graph 1 –Brazil: GDP
(annual variation, real terms)

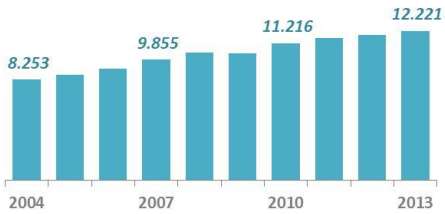


Source: IMF

Graph 2 – Brazil: inflation
(annual variation)

Source: IBGE

Graph 3 – Brazil: GDP per capita, PPP
(current USD)

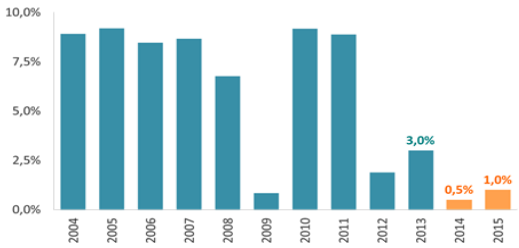


Source: IMF

Argentina: economic stagnation and exchange rate volatility

The situation in Argentina is more complex since it is also experiencing a process of economic slowdown like the rest of the emerging markets, the magnitude of its macroeconomic imbalances is a significant economic policy challenge which seeks to move in an which seeks to move in an orderly and credible way toward "sincerity" of some key variables such as the price of the dollar market, the cost of utility rates and inflation measurement, among others.

Graph 4 – Argentina: GDP
(annual variation, real terms)



Source: IMF

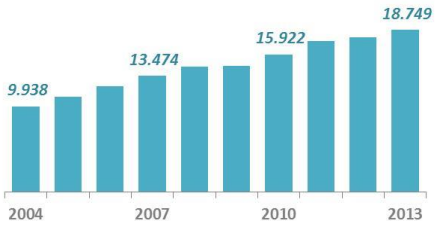
The projections of analysts surveyed by *Bloomberg* suggest that Argentina will not grow in 2014 and will do so only 1.5% in 2015. In any case, beyond these specific projections, Argentina will possibly recover low growth rates this year. This is explained in part by the financial stability that the government has pursued in recent months, which provides a clear *trade-off* compared to a more dynamic economy. In other words, attempts to boost growth could lead to financial instability. Thus, a scenario with further adjustments in the exchange market and little economic dynamism may be foreseen.

Graph 5 – Argentina: inflation
(annual variation)

Source: Statistics Institute of San Luis

In this context, the possibility of entering the international capital markets is one of the major challenges in the medium term. While in May this year Argentina had taken an important step in approaching the overall funding after reaching an agreement with the Club de Paris, the verdict of the Supreme Court of the United States met in June and rejected the Argentine case against holdouts (also known as "vulture funds"). This will give rise to new challenges in relation to access to funding and managing their stock of reserves.

Graph 6 – Argentina: GDP per capita, PPP
(current USD)

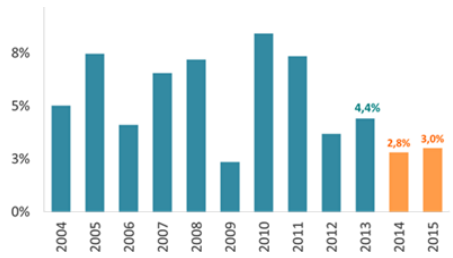


Source: IMF

Uruguay: inflationary persistence will restrict the margin of action

Since the beginning of 2012, the Uruguayan economy has been showing a consistent slowdown with a less friendly international and regional scenario. While the average growth rate between 2004 and 2011 amounted to 5.8%, the records for 2012 and 2013 stood at 3.7% and 4.4% respectively. In addition to the lack of dynamism, the heterogeneity in the performance of various activities has been one of the features that has characterized the Uruguayan economy in the last two years.

Graph 7 – Uruguay: GDP
(annual variation, real terms)



Source: IMF

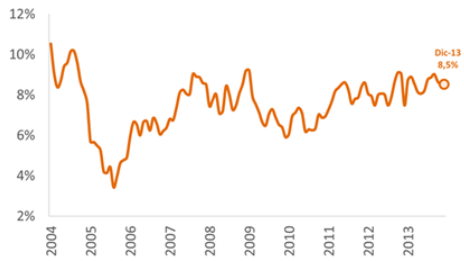
In this context, it is expected that economic growth will continue to moderate over the next two years, gradually aligning with its long-term trend (around 3%). Similarly, it is expected that the heterogeneity across sectors will be maintained. Particularly, the manufacturing industry will continue affected to be by the regional situation as

well as the "Construction" sector (which is also affected by the completion of the works of Montes del Plata).

Beyond this, certain macroeconomic imbalances lit a warning light in Uruguay. In particular, not only have inflation rates surpassed the target values, but it is very likely that said rates continue to be misaligned with the Central Bank's target values at least until 2015. Inflation persistence in a context of economic activity slowdown is one of the main challenges for the coming years. This is because on one hand, it restricts the margin of action to face a more moderate phase of the cycle, so the transition does not affect labor market conditions. On the other hand, in the context of strengthening of the U.S dollar worldwide, it may act as a limiting factor in achieving real depreciation, preventing the consolidation of significant gains in terms of competitiveness.

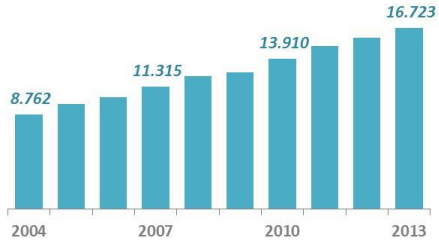
However, it is important to note that the economy has several reinsurances that could facilitate an orderly transition to the new scenario. In particular, the authorities have established a solid structure of liabilities through proper debt management of the non-financial public sector, as well as having a stock of international reserves at historically high levels. Also, the Uruguayan financial system is strongly regulated and has significant solidity, so it is very unlikely for Uruguay to be a channel of amplification and propagation of negative external shocks.

Graph 8 – Uruguay: inflation
(annual variation)



Source: National Institute of Statistics

Graph 9 – Uruguay: GDP per capita, PPP
(current USD)



Source: IMF

Global Competitiveness Index: Argentina, Brazil and Uruguay

According to the World Economic Forum, the deterioration of macroeconomic conditions in Argentina, Brazil and Uruguay has led to a recent loss of competitiveness. Brazil is relatively well positioned 56th in the Global Competitiveness Index (GCI), while Uruguay and Argentina have a GCI of 85 and 104, respectively, in a total of 148 countries

Argentina has enormous economic potential which is explained by the size of its market, the broad access to communication and information technology, and high university enrolment in the region which entails significant human capital supply. However, the bad position in global competitiveness is mainly due to a weak institutional framework. Evidence for this is the government's low efficiency and a level of corruption that is rated by the index as one the highest in the world (position 145, of a total of 148 countries). In addition, Argentina has

vulnerabilities of competitiveness in the labor and financial markets, and has limited access to international financing which threatens their macroeconomic balances.

When it comes to Brazil, the country is highly rated in the region but presents significant challenges. South America's largest economy is ranked as 56th in the GCI, which is explained by the size of its market and a business and innovation core dedicated to high value-added activities. However, the lack of progress in institutional functioning, openness to the world and the quality of physical and human capital is hampering its competitiveness.

Moreover, Uruguay differs from Argentina and Brazil in its institutional strengths. It has a privileged digital connectivity as a result of policies that were aimed at closing the gap with developed countries. After a decade of high economic growth, Uruguay nowadays requires significant reforms in key areas such as education, the innovation system and the capital market.

In short, these three countries are in very different positions in terms of global competitiveness. Their challenges are different but they share common obstacles, such as the quality of their human capital and their capacity in innovation and technology incorporation.

II.3 Economic structure and main industries of the countries

To analyze and understand the business opportunities offered by the region to the world it is necessary to understand the productive structure of the economic bloc. This productive structure is the main determinant in trade activities with the rest of the world; thus, possible complementarities between Mercosur and Russia will be identified based on said structure. In this regard, the following chapter will analyze the economic composition of the different countries of the region, its strengths and main trade activities with the world. Also, in this context, the position and characteristics of trade between Russia and Mercosur will be discussed.

Productive structure

The economic structure of the original Mercosur countries has an economic matrix that is strongly linked to the production of natural resources, particularly food products from the agricultural and livestock sector. In addition to being the main export, said products are the driving force of the economies, impacting the manufacturing and service industries. However, in the cases of Brazil and Argentina, the industrial sector is more mature and has been growing in recent decades and consequently diversifying the productive matrix of said countries.

Argentina is known for the importance of the agricultural sector as the driving force of its exports. The main export products include: soybean, corn, wheat, tobacco and citrus among others. The country also has a powerful industry dedicated to the production of chemical and metallurgical products, vehicles, and processed foods. With regard to the service sector, Argentina played an important role as an exporter of BPO[5] services, which then lost due to the low competitiveness of the sector. Currently, Argentina is one of the leading worldwide exporters of educational services, pharmaceuticals and activities related to information and communication technology.

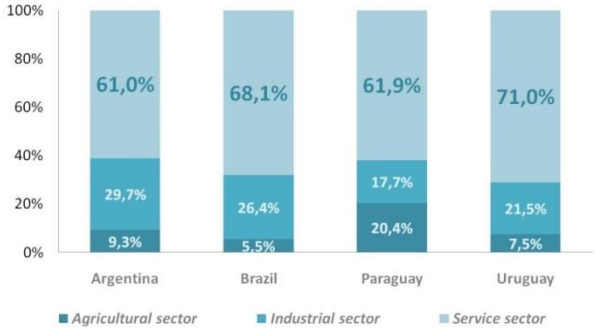
In the case of ***Brazil***, the productive matrix underwent a major transition from a mainly agricultural base to a diversified production base with a strong emphasis in the industry. Brazil ranks as one of the largest net food exporters worldwide, with coffee, sugar, soybean, poultry and bovine beef as its main products. In the industrial sector, Brazil focuses on automotive, iron and steel, mining, aviation and chemical production. With regard to the service industry, Brazil produces services relation to the IT and BPO sector.

Among the five members of Mercosur, ***Paraguay's*** economy is one of the most dependent of the primary sector production. The main products produced are cotton, wheat, corn, sugar and soybean, and Paraguay ranks as one of the leading producers worldwide. Its industrial sector on the other hand is relatively undeveloped, with the production of hydropower as the main feature and metallurgical and timber production focused to supplying the domestic market.

[5] Business Process Outsourcing

Lastly, ***Uruguay*** is a country dependent on the primary sector, with a significant production of raw materials, mainly related to food products which impact the industrial and service sectors. Bovine beef, soybean, wheat, corn, rice, sugar, timber and milk are Uruguay's main products. The production of these raw materials has impacted other sectors, resulting in a strong agro-industrial production, closely related to dairy, forestry and beef production.

Graph 10 – GDP sector composition by country, 2013 (% of total)



Source: CIA World Fact Book.

Foreign trade characteristics of the bloc

The productive matrix of the aforementioned countries determines the foreign trade characteristics that this countries display.

In this sense, in 2013 the bloc's exports amounted to about U.S. $ 278,000 million, of which roughly 90% accounted for Brazil's exports. The evolution of this variable shows a steady increase from 2001 to date, with the exception of 2008, year when the global crisis hit the economies of developed countries, negatively affecting the exports form the countries of the region.

Graph 11 – Exports of goods outside MERCOSUR by country
(USD thousand million)

Source: Trademap

The characteristics mentioned previously regarding the profile of the economy of each country is directly reflected in the characteristics of the products sold, both for export and import. In effect, the main products exported by the bloc belong to the primary sector and are mainly food products, primarily soybean, bovine beef and corn.

In the case of ***soybean,*** Brazil is the largest exporter in the world with 42.8 million tons, while Argentina, Uruguay and Paraguay are among the top five exporters in the world. The four countries together represent more than 55% of world soybean exports.

Moreover, regarding ***bovine beef***, Brazil is the second largest exporter in the world, with over 1.1 million tons in 2013 -India being the main exporter-. Argentina, Uruguay and Paraguay are among the top 15 exporters in the world, these four countries together represent more than 20% of total world exports.

In turn, Brazil ranks as the largest exporter of ***corn*** in the world with 26.6 million tons, while Argentina and Paraguay are ranked among the top ten exporters. Coupled with Uruguay, the four countries together account for 40% of world corn exports.

The main destination of exports from Uruguay, Argentina, Brazil and Paraguay in 2013 was China with a wide lead over other countries, accounting for approximately 20% of total exports, soybean being the main export.

From the point of view of imports, the bloc's main imports during 2013 were petroleum oils and gas, telephone devices, cars and pharmaceuticals, which largely responds to the level of development of the industrial sector. The primary origin of said imports is China, being China Mercosur's main trade partner since 2012.

As noted in the analysis of the business profile of the bloc's member countries, an export-based matrix associated with primary products and imported manufactured goods is observed. Although the region has tried to make progress in the development of the industrial sector, these efforts have not resulted in significant changes in the foreign trade structure of the bloc.

Trade with Russia

Although Russia is not among Mercosur's main trading partners, it is ranked as #14 with a total of USD 10,000 million traded in 2013, the characteristics of these blocs result in a complementarity of both regions.

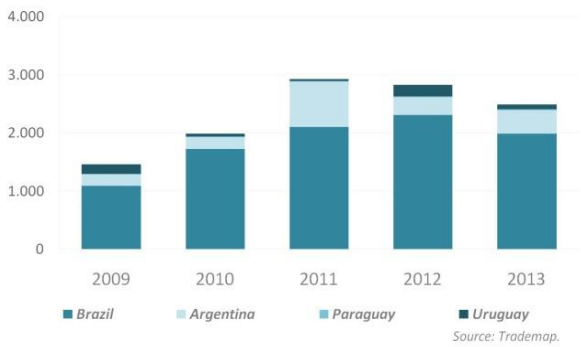
Russian imports from Mercosur are primarily food products. Mercosur's exports to Russia accounted for 1.8% of the bloc's total exports throughout 2013 and in turn represented 1.5% of total imports from Russia in the same year. The top ten items exported by the bloc to Russia accounted for 78% of exports and among the main products were bovine beef, sugar, soybean and tobacco.

In turn, Russia is one of the largest natural gas and petroleum oil exporters worldwide. Mercosur's energetic limitations have historically been a problem for the member countries. Recently, several countries in the region have discovered or begun to explore the possibility of extracting oil and gas from their territories, as a result creating an opportunity for the exchange of know-how to carry out these operations.

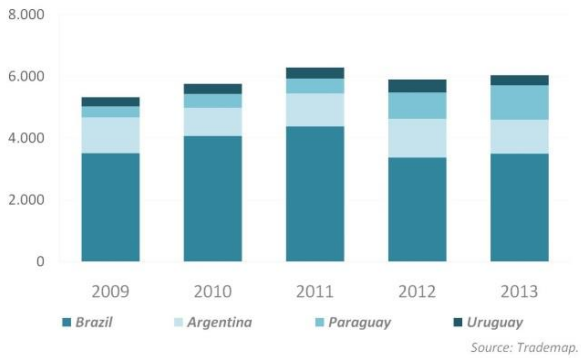
Mercosur's imports from Russia are primarily fossil fuels and mineral fertilizers. They represented approximately 1.5% of Mercosur's total foreign purchases in 2013 and less than 1% of Russia's total exports.

The economic structures of Mercosur and Russia result in complementarity of both blocs, both from the point of view of the trade of goods and from the exchange of know-how developed in each region. While current trade clearly shows this complementarity, there are possibilities of increasing and greater developing said exchange.

Graph 12 – Exports to Russia by country
(USD million)



Graph 13 – Imports from Russia by country
(USD million)



II.4 Financial system of the region.

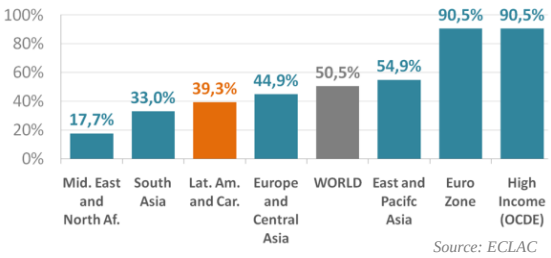
The following section will give a brief overview of the main features of the financial system in the region. The analysis will include the financial systems of Uruguay, Brazil, Argentina and Paraguay, following the same line of thought developed in the previous sections. In addition, a brief analysis of the Chilean financial system will be included, given it's one of the most developed countries in the region and often used as a *benchmark* for other countries.

Context

In recent years, financial systems have undergone transformations and Latin American countries have not escaped from these transformations. Among them we can mention: regulatory changes to strengthen the solvency and liquidity of the systems, increased concentration among institutions, anincrease in the importance of technology as a key factor in the competition for attracting and retaining customers, increasing specialization in the regions banking entities and consolidation of new non-financial institutions that provide financial services.

In this context, although the financial systems of the countries in the region have developed positively in recent years, they still face the challenge of continuing to develop. Firstly, financial systems have insufficient capacity to channel domestic savings into production and infrastructure investments. Secondly, there is a relative delay in the capacity of financial inclusion, leaving large groups of people and companies outside the formal financial cycle.

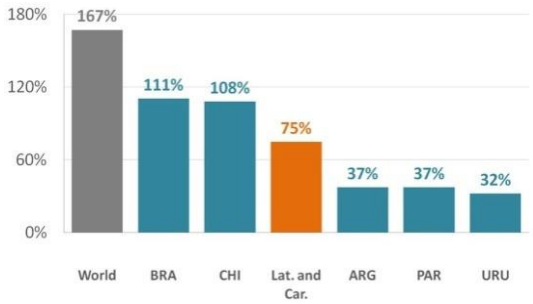
Graph 14 – Population over 15 years with financial institution
(% september 2011)



Source: ECLAC

In regard to financial inclusion, Brazil and Chile are one step ahead of other countries in the region. In effect, both in Brazil and in Chile the percentage of population with a formal financial account has surpassed the average values for Latin America in recent years. Brazil alone reached 56%, surpassing the world average (50.5%).

Graph 15 – Credits to non-financial sector, 2012
(% of GDP)



Source: World Bank

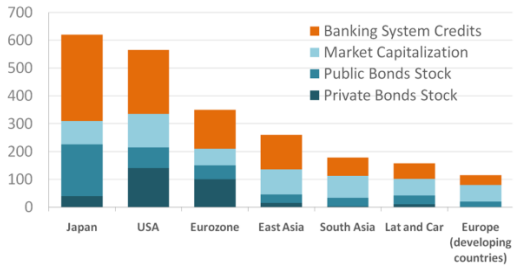
In relation to the depth of the system, measured as domestic loans to the non-financial sector (NFS), in terms of GDP, Brazil and Chile are above the average for Latin America. However, the region as a whole lags behind the world average.

Analysis of the Components of the Financial System

Financing needs of the productive sector (whether it's for an initial stage, to finance working capital, for growth capital, etc.) vary in each stage of the company.

Four types of components that make up the financial system can be identified: i) domestic bank credit, ii) market capitalization, iii) stock of government bonds and iv) stock of private bonds. Latin America, however, displays low levels of development in these components.Because of this, the funds available to finance the productive sectors are in general relatively low.

Graph 16 – Financial depth, 2006 – 2012
(Size of selected financial assets as % of GDP)



Source: ECLAC

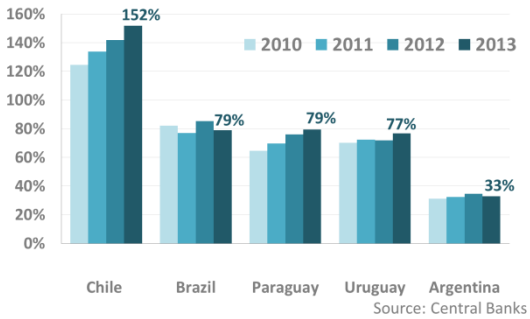
Thus, the depth of the financial system in Latin America as a whole (including the four components mentioned in the previous paragraph), was approximately 150% of regional GDP in the 2006-2011 period. These levels were well below some countries like Japan and the U.S. as well as the more developed regions (Eurozone, East Asia, etc.).

In the Latin American average, among the components considered, a predominance of loans granted by the banking sector as a source of funding (60% of regional GDP) was observed. Secondly, the stock market was at an average rate of 50%. Finally, the level of public debt stock (30%) and private sources (10%) was observed. The latter, marks a difference between the region and more developed countries where this type of financing by firms is widespread (as seen in Graph 16).

Evolution of the Banking System

The trends aforementioned have contributed to a further strengthening and dynamism of the financial system; which was also observed for the countries under analysis. Specifically, the volume of banking business (measured as the sum of deposits and bank loans) in terms of GDP, has increased in the five countries considered in the analysis. In particular, the case of Chile, where bank stocks have risen above the national product, implying that in the last three years the importance of banks in relation to the product, a 27% increase was noted.

Graph 17 – Turnover / GDP
(% of GDP)



Source: Central Banks

In contrast, Argentina showed the lowest growth in the region, reaching an increase of 2% in the period between December 2010 and 2013. Additionally, the Argentine financial system only 33% of the GDP, while Chile's was over 150%. Finally, Paraguay and Uruguay recorded intermediate levels: 79% and 77% respectively.

Banking concentration

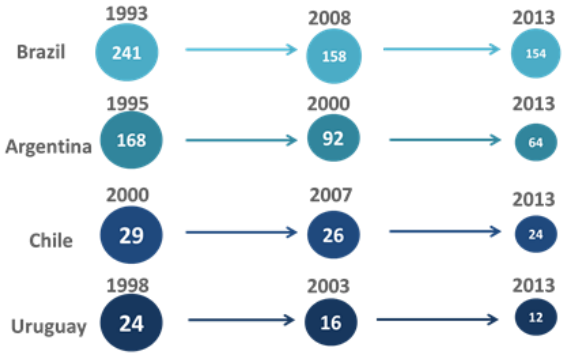
As noted, in recent decades there has been a banking concentration in most of the world's financial systems. In particular, banks in more developed markets such as the U.S., have been engaged in a process of mergers and acquisitions which led to the concentration of financial institutions, a phenomenon particularly aggravated by the financial crisis of 2008.

Both liquidity needs and regulatory requirements established after the crisis, defined a more rapid acceleration in the process of Merger and Acquisition of financial institutions in the region.

This can be seen by analyzing the level of share turnover (deposits plus credits) of the five largest banks in each country, and by focusing on the evolution of the number of institutions in recent years.

At the same time, Latin American banking institutions have increased their presence in the region. There has been a long process of mergers and acquisitions particularly by local banks in the region, highlighting the acquisitions of Banco Santiago by Banco Santander Chile, the Bank Itaúwhich acquired Bank Boston, GNB Sudameris (Colombia) by HSBC Colombia, Peru, Paraguay, Davivienda Bank by HSBC Honduras, Costa Rica and El Salvador, among others.

Ilustration 3 – Number of commercial banks by country



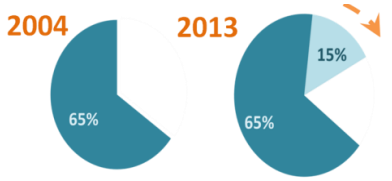
Source: Compilation based on each countries' Central Bank

Table 1 –Top 5 Banks Market Share, December 2013 (% turnover)

URUGUAY		CHILE		BRAZIL		PARAGUAY		ARGENTINA	
Bank	*%*	*Bank*	*%*	*Bank*	*%*	*Bank*	*%*	*Bank*	*%*
Banco República	*43,1%*	Banco de Chile	*17,3%*	Banco do Brasil	*22,8%*	Continental	*17,3%*	Nación Argentina	*24,9%*
Santander Uruguay	*16,2%*	Santander Chile	*17,2%*	Itaú Brasil	*18,8%*	Itaú Paraguay	*16,9%*	Provincia Buenos Aires	*9,0%*
Itaú Uruguay	*11,6%*	Banco del Estado de Chile	*15,4%*	Caixa Económica Federal	*13,7%*	Regional	*16,7%*	Santander Río	*7,5%*
BBVA Uruguay	*10,3%*	BCI	*12,4%*	Bradesco	*11,0%*	BBVA Paraguay	*11,2%*	Galicia y Bs. As.	*7,0%*
Scotiabank	*6,7%*	Corpbanca	*11,5%*	Santander Brasil	*6,9%*	Visión Banco	*6,0%*	Frances SA (BBVA)	*7,0%*
Total	***87,9%***	**Total**	***73,8%***	**Total**	***73,2%***	**Total**	***68,1%***	**Total**	***55,4%***

Source:Bloomberg

Graph 18 – % of regional Banks within Top 25 banks in Lat. Am. (by assets)



Source: Bloomberg

This process of banking concentration can be shown bythe depletion of the business model as we knew until recently, which could generate alternatives for other banking and financial services in the region.

In summary, although the financial systems of the countries of Latin America and the Caribbean have shown positive developments in recent years, financial inclusion levels are still low compared to more developed countries and regions. In turn, the degree of development of the banking systems of Uruguay, Paraguay and Argentina appear to be below the average for Latin America. Instead, Brazil and Chile are the most financially developed countries in the region, reaching in some cases even higher values worldwide. Moreover, the financial system in the region is composed mostly by domestic loans of the banking system. Unlike more developed countries, the development of stock markets and public and private bonds is relatively low. The combination of banking regionalization and concentration processes in Latin America have boosted the financial business.[6]

[6] Annex 5

III. Challenges and development constraints of the bloc and business opportunities

As mentioned previously, the favorable international situation has generated great dynamism in the export and import sector in South America. As a result, the marked development of the export sector coupled with a thriving import activity, impacted on the demand for the logistics sector – a result of the accumulated investments' deficit-and in turn slowed down the growth of the region's economies.

In this chapter the evolution of supply and demand for logistics services in Mercosur is briefly discussed, with emphasis on the infrastructure deficit. In this sense, a reference to growing economies and its impact on the demand for logistics services will be done. Subsequently, an analysis will be performed considering the supply of logistics services and the shortcomings that countries of the region are facing in this respect. Finally, an analysis on the most active authorities in terms of infrastructure financing in the region will be made.

III.1 The demand for logistics services: the dynamism of the agriculture and livestock sector and the challenges in terms of infrastructure.

In the past decade the Mercosur countries faced extremely favorable external conditions. Motivated by an increased global demand for food and raw materials, mainly from China and India, the volumes and prices of products exported by Mercosur countries reached the highest historical levels. In the case of food prices, they rose to levels similar to price levels in the 1970s, world historical peak.

Both the increasing world population and a middle class that demands higher levels of protein along with a sustained demand for food and raw materials from China, led to sustained growth in demand for food and raw materials. Additionally the growing demand for grains for biofuel production is also an important variable. All this has generated a sustained and growing demand for Mercosur's export products, which is expected to continue in the short and medium term. This will surely lead to the maintenance of a dynamic agro-exporting sector which demands efficient logistics.

Evolution of the agro-exporting sector

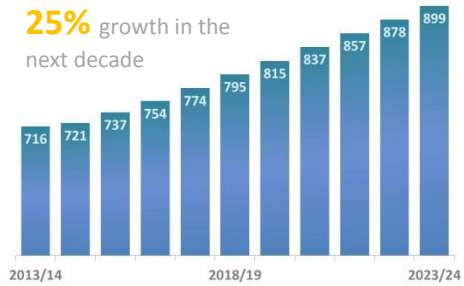
Due to its characteristics as commodity producers, the development of the agricultural sector has been closely linked to the growth of the countries of the region. Driven by a growing demand and high export prices, Mercosur countries have consolidated an agro-exporting sector in the last decade which has become a major driving force of domestic economies.

Because of its nature, the sector requires the transport of the product from the production units hinterland to ports for its subsequent transfer to the final destination. It also needs to take the reverse route for fertilizers, seeds and production machinery. Therefore, in order for the sector to continue this path of sustained growth, it is necessary that the goods move without interruptions both within and across borders.

Thus, the dynamism of the agriculture and livestock sector significantly impacts other sectors of the economy. On one hand, it increases the need for a logistics sector capable of providing the necessary inputs for agriculture and livestock production and on the other hand it needs to have a logistics basis which is capable of transporting agriculture and livestock production from the country to the ports where the production will embark to overseas destination. Because of this, developing an efficient logistics sector is a precondition for the development of a competitive export sector.

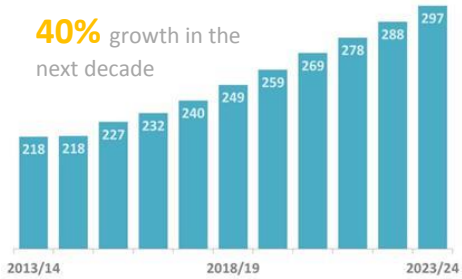
If the main drivers of the agriculture and livestock sector worldwide continue with the prospects of current growth, it is expected that the export sector of the region will maintain the dynamism, demanding logistics services in the region.

Graph 19 – World exports projections, all agricultural products 2013-2023 (million tons)



Source:Trademap

Graph 20 – Mercosur exports projections, all agricultural products 2013-2023 (million tons)



Source: USDA

III.2 Logistic service offerings in the region: performance and infrastructure investment deficit

Importance of the logistic sector in the modern world

The efficiency of the logistics industry today is a key aspect in the economic development of a country. Whether it follows the national development strategy or not, a key component is the way in which the country is dynamically inserted into the main global trade routes.

A key aspect in raising awareness of the importance of the logistics industry –process which stated in the 1990s- is the emergence of globalization as a great umbrella under which various forces operate: i) the liberalization of world trade has strengthened in the past two decades, ii) the rise of China as a world power, iii) the rise of global value chains that involve not only an increase in the circulation of final goods but also intermediate inputs, iv) the advancement of ICT that had a positive impact on world trade and in the development of the logistics sector. This set of forces caused the volume of world trade to increase three-fold in the last twenty years.

In this manner, globalization gave place to several worldwide changes that increased the importance of the logistics sector as a key sector for the fulfillment of the development strategy of a country. In effect, an efficient logistics industry significantly impacts the economy by reducing transport costs, facilitating trade and increasing profit margins of domestic producers, which implies an increase in competitiveness. Because of this, the logistics sector is an important source of transversal growth for many sectors of the economy.

As mentioned previously, the growth of Southeast Asian and South American emerging economies defined a suitable stage for the logistics sector to become even more essential in the overall trade scheme in the coming years. In view of this, particularly given the critical role of the logistics industry for the development of Mercosur, the following chapter analyses the logistic performance of the countries of the region as well as the critical components to be considered in order to improve in this regard.

Logistic performance of the Mercosur countries

Evaluating the logistics performance of an economy involves assessing the ease with which goods can move from one point to another, across or within borders. With this objective, the efficiency of the logistics sector is evaluated through the assessment of the following areas: customs efficiency, quality of infrastructure related to trade and transport, ease of making deliveries at competitive prices, quality of logistics services, ability to track and trace shipments and timeliness of the service.

As we approach the logistics performance of the Mercosur countries in recent years, we find that the measurements indicate that both Brazil and Argentina have a performance above the

average of the other member countries. On the other hand, Paraguay underperforms with respect to the global average throughout the period considered. On the other hand, Uruguay which until 2012 displayed a favorable performance, is projected to fall 35 places in the ranking[7] in 2014, ranking as the country with the worst Logistics Development Index in Mercosur.

While analyzing each of the assessed areas, it is possible to observe that all the Mercosur countries have significant lags in terms of the different categories of ranking. However, one of the main constraints and challenges that the bloc faces in order to embrace the opportunities that are opening up in the region to "global business" is the development and improvement of infrastructure in the logistics sector.

Illustration 4 – Logistics Performance Index (LPI) 2013

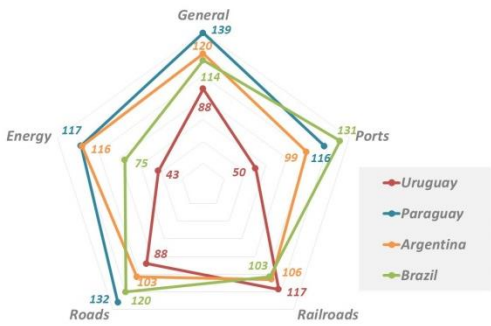
Source:World Bank

III.3 State and infrastructure challenges

A key aspect for the region's infrastructure development strategy is to have an infrastructure that is aligned with the current needs and growth prospects of the economy. The region's characteristics require that infrastructure investments prioritize foreign trade both within the region and to the rest of the world. To assess the state of the infrastructure and therefore the need for investment in these sectors, this section will analyze the state of the road, rail, port and energy infrastructure in the countries of the region.

The World Economic Forum (WEF) analyzes the infrastructure of a country through the following dimensions: quality of roads, quality of aviation infrastructure, quality of energy infrastructure, quality of railways and the overall quality of infrastructure. The latest data from the WEFdisplayed that Uruguay had better results than the rest of the Mercosur countries in all areas with the exception of railway infrastructure. However, it is important to take note that generally all countries in the region show a significant lag in the dimensions analyzed, reaching underprivileged positions globally. Next, some infrastructure characteristics of the region will be outlined.

Graph 21 – Ranking quality of infraestructure
(Global Competitiveness Report 2013-2014)



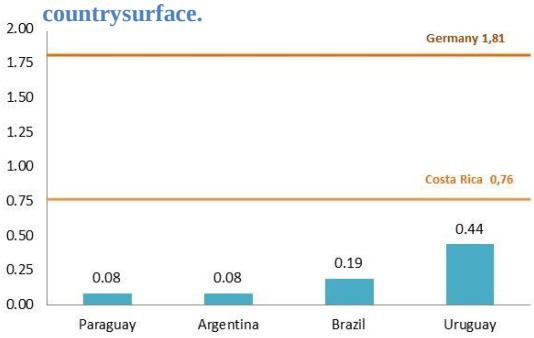
Source: World Economic Forum.

[7] General weakness in all of the index areas, particularly the areas of Customs Efficiency, Quality and Logistic Competence and Availability for International Transport.

Road infrastructure

With regard to road infrastructure, the region is facing shortcomings in urban and rural road works. The growth in per capita income over the last decade has promoted an expansion of the fleet that was not accompanied by an investment in road infrastructure. In Brazil (4th largest seller of cars in the world), in Argentina and Uruguay the number of cars sold in the last decade increased two-fold, reaching in 2013 the 4.5 million cars sold in 2013.

Graph 22– Road extension (km) per km^2 of countrysurface.



Source: CIA World Fact

Furthermore, in rural roads, although Uruguay is the country with the highest density of Mercosur, all member countries are well below two countries that are used as a reference: Germany, because it's considered to be the country that has the highest infrastructure development in a medium size country and Costa Rica because of the high road density level in a developing country.

The deficit in urban and rural road infrastructure represents the first limiting factor in terms of infrastructure for the development of the logistics sector. In view of the marked deterioration and growth prospects in the use of these paths accounted for the increase in trade, as well as the expansion of the fleet, it would seem necessary to allocate investments in this sector in order to maintain the level of competitiveness of the region.

Railway Infrastructure

One of the factors noted as a possible cause of the difficulties that the road transport system is currently facing is the poor development of the railway sector in the region. Beyond certain expressions of interest by governments to revive railways as a means of transporting goods, investments in the sector have been inadequate and summarized to merely maintaining the facilities, which in many cases were insufficient.

Most railway systems in the region were created more than 150 years, with strong growth in the region in the second half of the nineteenth century and early twentieth century. However, in the 1940s, different political and social changes started to take place and led to the nationalization of several concessions. This way, gigantic government-owned railway companies were created which were very difficult to manage and control.

The way in which these companies were conceived led to a situation where the railroad lost importance and road transport gained importance. On one hand, these companies had difficulties understanding the changing market conditions and competition. On the other hand, said companies were unable to provide reliable and regular services, offering low quality service. Finally, these companies inherited a large group of employees which was difficult to manage and handle, generating large fiscal deficits.

However, in the 90s significant reforms in the region's railway sector started to take place. Two of the most important changes were the introduction of private management in railway operation and fragmentation of large companies in several smaller government-owned railway companies. Furthermore, freight, a more profitable way of railway transport was separated from passenger transport, which often remains as part of the public sector. Currently, there are 38 cargo operators in Latin America and the Caribbean of which 32 are run privately and mobilize 99% of freight in the region, while the remaining is mobilized by 6 government-owned companies.

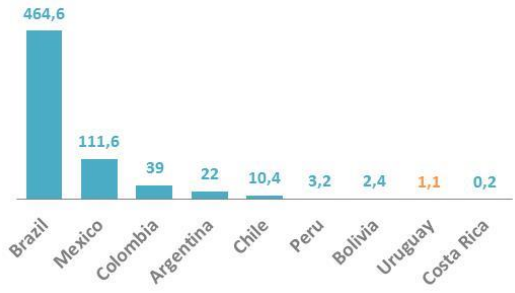
The transfer of the railway companies from the public to the private sphere was implemented mainly through concessions. In these, the state retains ownership of fixed assets and charges a fee to the private company for the use of its assets. The term of the concession is approximately 30 years. This mode of operation was, in general, the most financially feasible, rehabilitating the traditional railways and adding new equipment.

The rail systems in the region present substantial differences among them. Brazil is the country with the highest number of tons carried per year (464.6 million). At the other end, Uruguay is a country that carries less cargo per year: 1.1.

Similarly, Brazil is the country that used railway transport more than any other kind of transport. Consequently, the countries with higher percentages of goods transported by railway are those with the most extensive railway network.

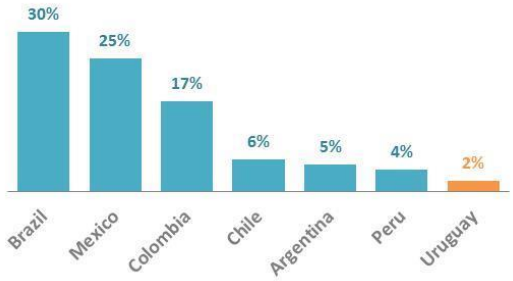
One of the key aspects to explain the low penetration of the railway transport of goods is the efficiency with which they operate. A measure of the efficiency of rail transport is the amount of tons-km[8]that a locomotive transports per year. In Uruguay, the government-owned railway company carries 10 million ton-km per locomotive, ranking in the top 5 worst performing of the 38 Latin American countries. While the most efficient in Latin America is Estrada de Ferro Carajás (Brazil) which carries 432, North-South Ferrovia (Brazil) which 314 carries, and the Estrada de Ferro Vitória a Minas (Brazil) which 245 carries.

Graph 23: Rail traffic (million tons per year)



Source: Latin American Railway Association

Graph 24: Share of rail transport (%)



Source: Latin American Railway Association

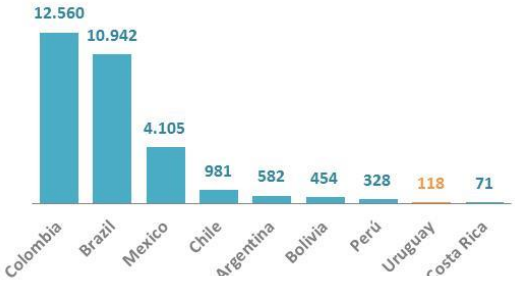
[8] Tons-km is the value obtained from the product between the number of tons and the number of kilometers travelled.

On the other hand, the productivity of wagons (million ton-km per wagon in service) of Uruguay is 0.36. The comparison with the rest of the Latin American companies ranks Uruguay in the first (worst) decile, surpassing only Argentine Belgrano Cargo (0.25) and Mesopotamian ALL (0.22). On the other hand, the most efficient are the Brazilian railways: the Estrada de Ferro Carajás (8.23), North-South Ferrovia (4.22) and the Estrada de Ferro Vitória a Minas (3.89).

Staff productivity (million ton-km per employee) reveals that the State Railway Administration (Uruguay) is the least efficient: 0.21. On the other hand, the 5 most efficient companies in these terms range from 10.67 (Estrada de Ferro Vitória a Minas from Brazil) to 2.27 (Ferrocarril del Pacífico from Chile), the five other most efficient companies are Brazilian.

As a result, Uruguay is one of the countries that uses railway transport the least. As seen in the chart, one ton per km circulates in Uruguay every three days, in Colombia 34 tons per km circulate per day and in Brazil 30 tons per km circulate per day. This measure indicates that the use of railways in Uruguay is substantially lower than in the countries of the region.

Graph 25: Use of railways
(tons per km of railroad per year)



Source: Latin American Railway Association

The development of an efficient and high quality railway is a key factor in the development of the region. The railroad has several advantages that make it the most economical and efficient way to transport low intensity goods in value per volume. In addition, it offers the ability to quickly collect large volumes of production in times of harvest in the production areas, improving the turnover of goods and reducing the need for storage.

One of the opportunities offered by the still unexplored railway system in the region is the central position of the Uruguayan railway system and its interconnection with the other Mercosur partners. Railway development in Uruguay could connect areas of Argentina and Brazil that are far away from their ports with respect to Montevideo and eventually a deep water port in the oceanic coast of Uruguay. In this manner, Uruguay could become the gateway for a great fraction of Argentina's and Southern Brazil's agriculture and livestock production.

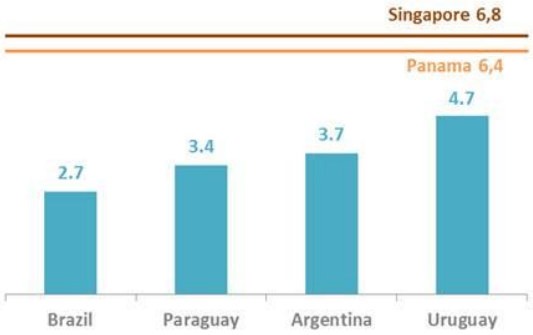
At time of writing this report government-owned companies China Railway Construction Corporation (CRCC) and China Railway Materials Commercial (CRM) have shown interest in the renovation of certain stretches of roads in Uruguay. While CRM has signed an agreement of understanding with the State Railway Administration (AFE), following a visit to Uruguayan technicians, the company would have made a proposal that was ultimately unsuccessful. Furthermore CRCC has contacted the Uruguayan government expressing their interest in repairing a section of a track with an estimated cost of US$ 300 million, said project is still under study.

The development of railway infrastructure would be one of the largest developments in the region in terms of logistic service infrastructure. The lack of long term investment in this area seems to have missed the great capacity of the railways to decongest the roads and make land transport more dynamic.

Port infrastructure

The recent development of foreign trade stressed port infrastructure in the region. As a gateway for the exported goods, the ports of the region have become bottlenecks, slowing down the normal flow of goods. This has resulted in a limited capacity to receive ships with large cargo and saturation of the facilities, which has in turn resulted in increases in loading, unloading and transfer times, increasing operating costs.

Graph 26– Quality of port infrastructure, 1-7 scale (higher average score means higher degree of competitiveness)



Source: CIA World Fact

According to the World Bank, Uruguay's port infrastructure is the best in Mercosur. Nevertheless, it is well below two of the world leaders: Panama and Singapore.

The main maritime outbound routes of the region are the ports of Buenos Aires (Argentina), Montevideo (Uruguay) and Rio Grande do Sul (Brazil). These three ports comprise the exporting logistics platform of central Mercosur.

Both the port of Montevideo and the port of Buenos Aires are located in the Río de la Plata. Through the Paraná-Paraguay Waterway, the Rio de la Plata becomes the entrance and exit to Paraguay and Bolivia (landlocked countries). Overseas trade is made through its river ports, hence, the merchandise from international vessels must first be transferred to barges that a more suitable for river navigation. A key aspect in the logistics configuration of the region is the Free Port system of Montevideo[9]. This scheme gives the port of Montevideo a competitive advantage over the other ports in the region.

North of the central Mercosur area is the port of Santos, located in the State of São Paulo (Brazil), it's the output port for São Paulo's industrial and agriculture and livestock production. The scale of operation of the port makes it one of the major ports of South America. However, the infrastructure deficit results in long waits for ships entering the port and long lines of trucks to stop and pick up merchandise.

Apart from the importance of the aforementioned ports in the logistics of the region, there are two very important river ports: Rosario (Argentina) and Nueva Palmira (Uruguay). These ports are essentially bulk carriers, primarily carrying agriculture and livestock products from the agricultural region of Argentina, Paraguay and Uruguay. Said bulks embark on larger

[9]Free Port Annex

international vessels. These ports are also a connection platform between barges that go from the Paraná-Paraguay Waterway into the Uruguay River.

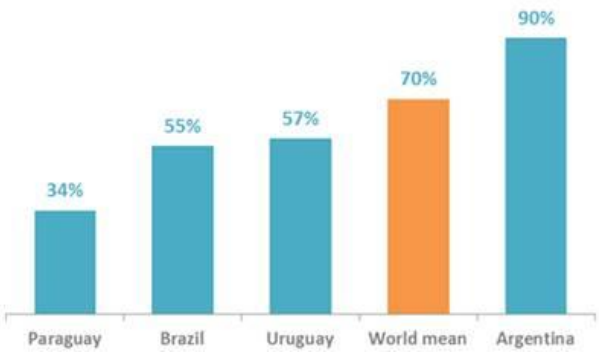
In short, the state of port infrastructure is operating as a bottleneck for the export and import businesses in the region's economies. The possibility to expand and improve the capabilities of existing ports and develop a deep water port on the Atlantic coast of Uruguay, are alternatives that are under consideration to improve these limitations.

Energy infrastructure

Over recent decades, the countries of Mercosur bet on hydropower as the main source for their economies. Since the 1970s, over 30 dams (among which is the second largest in the world-Itaipu dam-) were constructed to meet the demand of the countries. However, the feasibility of building new dams is already greatly reduced. As a result, dams have not been built in the last decade and countries have been forced, with the exception of Paraguay, to resort to alternative sources to meet increases in demand for energy. In effect, Argentina started using hydrocarbons (mainly oil and gas), Uruguay started using renewable energy generation (such as biomass and wind en) and gas, and Brazil uses a much more diversified combination of alternatives.

It is important to note that the energy matrix of the Mercosur countries is quantitatively and qualitatively different. On one hand, in Paraguay, hydropower surpasses product generation of dams shared with Brazil and Argentina. As a result of this, Paraguay does not have to develop alternative sourced of energy nowadays.

Graph 27– Fossil fuels as a percentage of total energy sources.



Source: World Bank

At the other end, Argentina is the country in the region that relies more strongly on fossil fuels. Although it has a significant infrastructure for hydroelectric dams and expansion of economic activity in the last decade, energy subsidy policies stimulated the expansion of the demand beyond its production capacity. Because of this, Argentina had to resort to importing electricity from Brazil, Paraguay and Uruguay and gas from Bolivia.

Moreover, although Brazil started diversifying its energy matrix in 2000 to greener alternatives, the discovery of large oil reserves in 2007 turned Brazil into the country with third-largest oil reserves in the world. Given this changing scenario in recent years, fossil fuels have gained a more central role.

In the case of Uruguay, the lack of fossil fuel reserves has forced the country to diversify its energy matrix, using both hydropower and other renewable energy sources as alternatives.

Recently, the need to import fossil fuels has been supplied with imports from Venezuela, Ecuador and Iran to a greater or lesser extent. The state company that holds a monopoly on refining and marketing of fuels in the country (ANCAP) is conducting prospective studies of the sea floor in partnership with international oil companies. In this context, the first drilling is scheduled for 2015.

Thus, greater diversification and dynamism of the regional energy sector seems to be on track to lift some of the restrictions in order to cater for the energy demand that growth had generated in the past. The possibility of having reserves of fossil fuels in Brazil and perhaps in Uruguay, together with an increase in economic ties with Venezuela (by joining Mercosur) appears to have mitigated, at least in part, the uncertainty about the energy sources in the region. As a result of this, there is a need to generate adequate infrastructure in order to exploit and distribute said resources.

This scenario opens up opportunities for activities dedicated to providing funding for infrastructure development in the region. The following section identifies and describes the traditional sources of funding for the Mercosur countries for this type of endeavor.

III.4 Access to long-term financing to promote infrastructure projects

As noted previously, the countries of the region face significant needs for investment in infrastructure. In the region, investments involved in this kind of projects have traditionally been financed from national budgets and lending, either by multilateral credit agencies (World-WB Bank, Inter-American Development Bank - IDB and recently the Andean Development Corporation (ADC) or public debt. In the last decade, the credit banks in China have taken a greater role in the region in financing infrastructure ventures.

Main sources of credit in the region

Regardless of the financing provided by banks and national development funds in each country, funding infrastructure projects in the region has been historically linked to multilateral banks such as the WB, IDB and ADC.

IADB was founded in 1959 with the aim of reducing poverty in Latin America and the Caribbean and to promote sustainable and lasting growth. For this reason, the institution, which now has a capital of USD 101,000 million, finances projects of economic, social and institutional development and promotes regional integration. IADB is made up of 48 countries that divided by borrowers and non-borrowers. The borrowers, make up only by 26 countries of Latin America and the Caribbean are the only eligible countries for funding. On the other hand, non-borrowers benefit from IADB rules (such as the provision of goods and services for the implementation of IADB projects) but do not receive any funding. This second group includes the United States, Canada, China, Japan, South Korea and a number of European countries.

Another Latin American entity is the Andean Development Corporation created and 1970 and its mission is to promote sustainable development and regional integration in Latin America by financing projects in the public and private sectors, providing technical cooperation and other specialized services. It currently consists of 17 countries of Latin America and the Caribbean, Spain and 14 private banks. This is a development bank that has grown in the recent years, not only in terms of its presence in the countries of the region but also terms of approvals (USD 9.171 million in 2009 to 12,101 in 2013), disbursement (USD 4.584 million to 7.441 in the same period) and equity (USD 5.287 million to 7.817 also from 2009 to 2013).

This network of institutions remained essentially stable over the past fifty years. However, as noted in several studies, in 2005, two Chinese financial institutions started assuming a more significant role in the region for infrastructure investment: the China Development Bank (CDB) and the Export-Import Bank of China (Ex-im Bank of China). These banks stepped in to provide financing for large investment projects in Latin America, becoming a tool to implement the policy of the Chinese government in the region and clearly showing their intention to establish long-term ties with the Mercosur region.

Main destinations for funds

By analyzing the financing map for the region it is possible to observe that traditional credit institutions have focused on granting loans to countries with higher repayment probability. On the other hand, Chinese development banks have granted loans to countries with limited access to the international credit market. In turn, it is possible to infer that Chinese banks and ADC focused on financing infrastructure (such as loans granted by BDC to Petrobras, Petroecuador and PDVSA). At the other end, traditional credit banksfinanced government programs that were centered in the improvement of their management or in building schools and health centers.

Over the last decade, Chinese funding institutions were more active in granting loans to countries with limited access to international capital markets. While traditional credit agencies like the World Bank and the IADB have maintained their diversified credit portfolio in terms of the countries to whom they grant loans, Chinese financing has focused much more in countries like Argentina, Ecuador and Venezuela that over the last

Table 2– Funding in Latin America by country (2005-2011)

Million USD	Total	WB	IADB	China
Venezuela	44528	0	6.028	38.500
Brazil	39.628	15.338	12.559	11.731
Mexico	27410	14739	11.671	1.000
Argentina	26.774	7.164	9.610	10.000
Colombia	12118	6241	5.877	0
Ecuador	8.914	153	2.457	6.304
Peru	6113	3045	2.868	200
El Salvador	2.954	1.196	1.758	0
Guatemala	2887	1176	1.711	0
Panama	2.811	591	2.220	0
Costa Rica	2741	698	1.743	300
Dominican Republic	2.555	854	1.701	0
Other	14079	2169	6.730	5.180
Total	**193.512**	**53.364**	**66.933**	**73.215**

Source: China – Latin América database

Table 3 – Funding in Latin America by sector (2005-2011)

Million USD	Total	WB	IADB	China
Health	17.926	8.463	9.463	-
Education	7.008	4.389	2.619	-
Water, Environment	16.145	7.061	9.084	-
Public administratior	19.105	11.013	8.092	-
Finance, Trade	18.328	7.170	9.858	1.300
Housing, Infrastructu	38.098	-	4.397	33.701
Transport	27.693	7.192	8.821	11.680
Energy, Mining	30.061	2.565	7.576	19.920
Other	19.148	5.511	7.023	6.614
Total	**193.512**	**53.364**	**66.933**	**73.215**

Source: China – Latin América database

decade have faced difficulties in entering international capital markets.

As for the promoted sectors, there is a certain complementarity between the sectors promoted by traditional development banks and Chinese banks. Chinese banks seem to focus on infrastructure and industrialization (87%), investments tend to generate employment and growth. However, multilateral financing institutions have a set of more diversified purposes, such as investments aiming to develop government, society and environmental issues, in addition to generating employment and growth.

IV. Uruguay as a business platform for the region

IV.1 ¿Why invest in Uruguay?

Introduction

Located between Argentina and Brazil, Uruguay is a small open economy, traditionally known for its stability, safety, peacefulness and developed society.

95% of Uruguay's soil is productive land, Uruguay is open to foreign investment and its institutional framework ensures the stability of investments. Uruguay has positioned itself in the world as a competitive country in the field of agribusiness. It is because of these factors thatin spite of being a small economy with just 3.3 million people and a GDP of USD 55,700 million, Uruguay has become one of the leading exporters of bovine beef, soybean, dairy products and cellulose in the world.

During the last decade, Uruguay has consolidated a stable macroeconomic scenario, designing aggressive policies to attract foreign direct investment. Its tax incentive system grants local and foreign investors a tax exemption of up to 100% of their investment. In addition to this, Free Trade Zone and Free Port schemes promote export-oriented businesses, encouraging the development of other activities, such as logistics, outsourcing, call centers and financial centers, which attract customers across the region.

The comparative advantages of Uruguay in agribusiness, combined with aggressive policies to attract investment, position Uruguay as one of the main recipients of foreign direct investment in South America.

Table 4 – Uruguay: Main Indicators

Ranking	In South America	In the World
Democracy Index (EIU, 2012)	1	18
Corruption Perception Index (Transparency International, 2013)	1	19
Economic Freedom (Heritage Fundation, 2013)	2	36
Global Peace Index (Institute for Economics & Peace, 2013)	1	24
Economic Climate Index (Getulio Vargas Fundation & IFO, 2013)	2	-
Quality of Life (Mercer Quality of Living City Ranking, 2012)	1	77
Human Development Index (UNDP, 2012)	3	51
Global Competitives Index (Global Competitiveness Report, 2013)	6	85

Political stability and rotation of political parties

In the last thirty years, five political parties have had parliamentary representation in Uruguay, of which three have held office during said period. The other two parties have solely parliamentary representation.Thus, in a political system characterized by high stability, -especially considering the current political scenario- it is important to note that the three political parties with chances of winning the 2015 election have already held office in the last three decades. This gives Uruguay's institutional and political system a high degree of predictability.

Uruguay's left-wing party (Frente Amplio) held officeforthe first time in 2005 with President Tabaré Vázquez. In 2010, Frente Amplio won the elections again, and the country is currently under the chairmanship of President José Mujica. Alongside the Partido do Trabalhadores in Brazil (in office since 2002) and the Partido Socialista in Chile (2000-2010), Frente Amplio integrates the social democratic parties bloc. In this framework, Frente Amplio has implemented firm policies that are committed with macroeconomic stability, respecting the business climate, guaranteed free capital flow and promoting local and foreign investment. Also, supported by the increase in tax collections, Frente Amplio has increased public expenditure, especially in education, health and social welfare programs.

Favorable macroeconomic context

The Uruguayan economy is undergoing a major transformation, both in terms of its macroeconomic performance and in terms of business opportunities.

The last four decades of the twentieth century were characterized by high macroeconomic instability (cyclic and relative prices) that resulted ultimately in poor growth. The financial crises, fiscal uncertainty and price instability conditions deteriorated and damaged investor confidence. However, in the last decade, the Uruguayan economy has consolidated a period of stability and unprecedented economic growth unprecedented, reaching levels higher than in the 1950s. This process of rapid expansion has generated significant changes in the country's economic structure and the business climate.

A favorable foreign economic environment characterized by expansions of commodity prices, high global liquidity and capital flows to emerging markets, helped Uruguay. As a result, the growth between 2004 and 2013 was, on average, 5.6% per year, three times the average growth over the second half of the twentieth century (1.7%). Growth was supported by buoyant exports, mainly led by agribusiness and related services such as logistics and transportation, as well as telecommunications and construction.

A set of macroeconomic stability-oriented policies allowed Uruguay to consolidate a solid macroeconomic situation and overcome the inherited weaknesses of the banking crisis of 2002. Fiscal policy aligned with the countries limitations allowed the country to reduce public debt from 100% of GDP in 2003 to 59.4% of GDP in 2013, progress in debt dedollarization, extenddebt due dates and reduce the need for short-term financing. Due to a strong growth perspective, improvements in tax policies and debt exposure in 2012 Uruguay regained its investment grade rating for its sovereign debt which allowed the country to be part of the same group as Chile, Mexico, Brazil, Peru, Colombia, Panama and Costa Rica.

Taking advantage of the increase in global food demand, Uruguay's total exports reached U.S. $ 13,600 million in 2013, five times the total value of exports a decade ago, with agribusiness as the main driving force. Agricultural commodities and its derivatives comprise approximately two thirds of exported goods, bovine beef, soybean cellulose and dairy products are the main exports. The growth of agribusiness in Uruguay from 2003 to 2014 has been remarkable. For

instance, the total area destined to soybean production increased 10-fold in the last decade, while bovine beef exports increased 4-fold in the same period.

In spite of the improvements reached in matter of inflation during the last twenty years, price stability is still one of the main problems of the Uruguayan economy in the short term. Average inflation in the past five years reached 7.7%%, consistently ranking above the goals of the Central Bank since 2007, and ranking among the highest of the region's economies.

Stable institutional framework

Uruguay is a country with a stable institutional framework and with a deep respect for contracts and property rights. Both the Legislative and Executive Branch operate properly while the Judicial Branch operates independently.

Uruguay is internationally recognized as having a low level of corruption and impact on private business operations. In fact, along with Chile, Uruguay is first in Latin America in the Corruption Perceptions Index published by the Transparency International Organization. In addition to this, the Global Competitiveness Report published by the World Economic Forum positioned Uruguay as the country with the lowest incidence of crime and violence in business in Latin America.

Social stability

Economic growth in the last decade has been an inclusive process from the social standpoint, generally impacting the lifestyle of the population in a positive way. Unemployment has declined consistently since 2003 reaching levels close to 6% of the active population, while real wages have grown at an annual average of 4% in the same period. As a result, poverty and extreme poverty have decreased steadily reaching historically low levels.

Policies such as welfare payments for the unemployed and the redesigning of the public health system have contributed to reducing the vulnerability of the most fragile sectors of society.

Regardless of this recent process of social inclusion, Uruguay has traditionally been a peaceful, developed and educated country. Firstly, education is secular, free, compulsory and publicly funded. Citizens have access to public education ranging from pre-school to University level. Recently, Uruguay was one of the first countries in the world to develop digital social inclusion through the "Plan Ceibal" initiative, which provides a free laptop for every primary and secondary school student.

Friendly with Foreign Direct Investment

Uruguay has historically been open to foreign capitals. Law N°16.906 from 1998 grants foreign investors the same treatment as Uruguayan investors including free capital transfer and profits in freely convertible currencies.

There are no restrictions on citizenship or place of residence for shareholders, owners or corporation directors (except for some specific activities that are considered of national interest such as broadcasting, longs distance bus lines or land estates in border regions).

Since 1974 foreign exchange market operations are completely free. The purchase and sale of foreign currency and payments made abroad in foreign currency are not subject to any restrictions. There are no commercial or financial legal obstacles in relation to foreign currency. In the case of contracts, if both parties reach a common agreement, the enforcement of contracts can be made in both local and foreign currency.

This institutional and legal framework enabled Uruguay to benefit from the growing interest of various agents to invest in emerging countries that are efficient food producers. Foreign Direct Investment (FDI) has grown steadily in recent years, reaching US$ 2,800 million in 2012, 12 times the investments reached in the last decade. FDI now accounts for 5% of GDP, which turns Uruguay into one of the largest investment recipients of South America after Chile.

Agribusiness and the real estate market have been the main destination of FDI in recent years. Investments in productive land recorded significant growth from 2003 onwards. Between 2004 and 2013, about 5.5 million hectares were sold (representing one third of the total productive land), equivalent to $ 9.5 billion, which increased six-fold the price of land in the same period.

The meat industry was also a destination for FDI. Mergers and acquisitions allowed the entry of international and regional industry groups, who won a significant share of exports in the sector. Companies like Marfrig (Brazil), Minerva (Brazil), JBS (Brazil), Perez Companc (Argentina), among others recently bought slaughterhouses, accounting for 25% -30% of the total production.

The forestry industry was also one of the favorite FDI destination, to the extent that approximately one million hectares benefited from tax exemptions to be used in commercial forestry. Two large pulp production factories settled in Uruguay in the last seven years, reaching a total investment of USD 5.5 billion (the largest investment projects in the country's history). Botnia (now UPM), was built in 2007, while Montes del Plata (StoraEnso - Arauco) was completed in late 2013 and early 2014. Both plants have an exporting capacity of about three million tons of pulp annually, with an estimated value of USD 2 billion. International companies such as UPM, Stora Enso, Arauco, Ence, Weyerhaeuser, Global Forest Partners LP and RMK Timberland Group have invested in forestry in Uruguay in the last ten years.

Currently, two groups of projects are under construction: the installation of windmills by 20 private companies with an estimated 2,000 million USD investment and a regasification plant by GDF Suez, worth roughly USD 1,100 million.

Some of the main projects in the Uruguayan pipeline are:

i. Iron mining (Zamin Ferrous) for approximately $ 3,000 million.
ii. Oil Exploration (Total, Tullow Oil, BP and BG Group) for approximately $ 1,500 million

iii. Deep-sea port: approximately USD 1,000 million
iv. Third pulp mill: approximately $ 2,000 million.

Uruguay as a gateway to Mercosur

Uruguay has positioned itself not only as a logistics hub for imports coming to the region, but has also sought to become a gateway for agriculture and livestock production in the region. The port of Nueva Palmira is located in southwestern Uruguay (close to the border with Argentina) and functions as an output port for grains mainly from Bolivia, Paraguay and Argentina.

The possible construction of a deepwater port in the oceanic southeastern coast of Uruguay would allow direct access to the Atlantic Ocean with 20 meters draft, a unique feature in the region. This construction will double the capacity of Uruguayan ports. This project is considered strategic for two reasons. Firstly, it increases the competitiveness of the country, reducing bottlenecks related to infrastructure. Secondly, it will consolidate Uruguay's position as a regional hub, not only as the region's input port, but as a gateway for exports from Paraguay, Bolivia, Argentina and even southern Brazil.

This portwas initially perceived as a multi-purpose port operating with different terminals for different cargo characteristics. It is estimated that the necessary investment is 1,000 million. The current government has announced that 42 companies from 13 different countries have formalized their interest in developing this project on the basis of a public port that will be designed, built, operated and funded by the private sector through a public-private partnership following Law N° 18.786.

However, there are some aspects that must be taken into account in order to design the deep water port construction project. First, Uruguay still has much to improve in terms of infrastructure in order to deliver logistics of competitive quality. As previously mentioned, Uruguay's logistics performance, measured by the World Bank, remains relatively mediocre. It's below the average for South American countries it is overtaken by its neighbors Argentina and Brazil.

Secondly, if the construction of the port on the Atlantic Ocean is actually intended to be used as a tool to help redefine the external insertion of the country it should be noted that a new terrestrial network (road and / or rail) be created in order to directly connect the west and the Atlantic coast. This means that the construction of the port implies an effort of resources and coordination of actions at a superlative scale for a country the size of Uruguay. In the event that a redefinition of the terrestrial network does not occur, the deepwater port won't become the key gateway for the region. If the port does not actually become this key gateway, it is likely that the construction of the port won't be feasible

Finally, although a formed opinion is premature, most experts on port issues indicate that a project such as the construction of the deepwater port requires activities that ensure a

feasible minimum scale of operation. Said activities are related to mining and energy projects; especially oil buoys[10.]

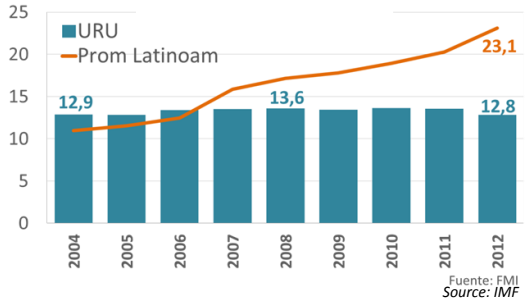
IV.2 Banking sytem in Uruguay

Introduction

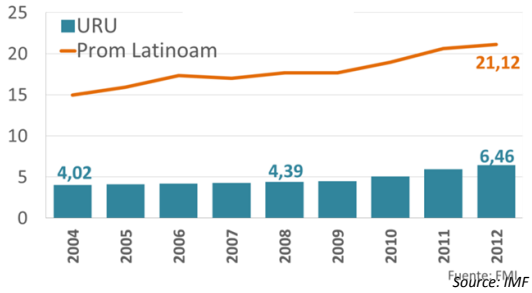
The Uruguayan economy showed extraordinary dynamism in the last decade, characterized by a strong process of asset formation, reaching the highest rates of investment since 1948. Nevertheless, the Uruguayan banking system showed moderate growth with a turnover below GDP growth, characterized by low credit penetration, a low level of development of the service sector and relatively low levels of profitability compared to the other countries of the region (however, this trend seems to be changing in recent years, due to the sharp increase in positive results in Uruguayan banking).

Uruguay has a financial lag with respect to the region. This can be seen both in terms of (i) Depth, Uruguay has submitted one of the lowest credit-to-GDP ratios in Latin America, which in turn is below the average of developed countries, (ii) Coverage and (iii) intensity of banking service use.

Graph 28 – Evolution of the number of bank branches (per100,000 adults)



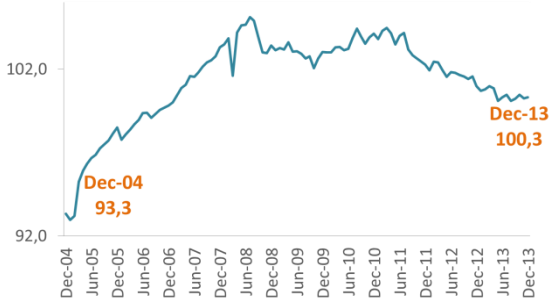
Graph 29– Evolutionn of the numer of ATMs (per1,000 km^2)



System strengths

The strength of the Uruguayan banking system has increased significantly since the last economic crisis in 2002. The Financial Strength Index prepared by CPA-FERRERE (IFF) quantitatively represents how the strength of the Uruguayan banking system has evolved positively since the 2002 banking crisis, and consolidated a scenario of great stability of the financial system. The Index's slight negative trend in mid-June responds to regulatory changes that increased regulation of the banking system and are perceived as negative by the index, nonetheless, it is not a significant change in the assessment of the system's stability.

Graph 30– IFF CPA-Ferrere (Jan 2007=100)



Source: Own elaboration based on CBU

[10]The buoy must be transferred from José Ignacio, which is not unreasonable given its half-life is not far from being reached.

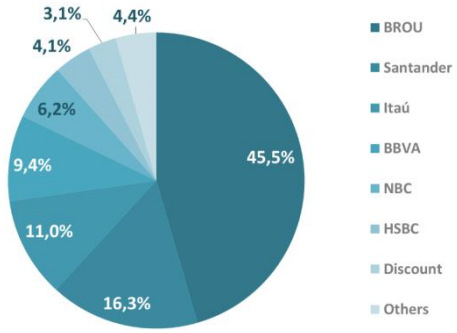
Morphology of Financial Businesses in Uruguay

At present, the Uruguayan financial system has a variety of financial institutions, among which are: i) Banks, ii) Business Credit Administrators (BCAs) iii) Financing institutions and iv) Credits Unions. The Central Bank of Uruguay (CBU), through the Financial Supervision is the institution responsible for regularizing the operation of such entities.

Banks are the institutions with the largest range of powers in undertaking financial intermediation activities, making them key players in the Uruguayan financial system. In particular, the set of banking institutions is composed by eleven private banks and two official banks. The Banco de la República Oriental del Uruguay (BROU) is one of said official banks and operates as a commercial state-owned bank. The other official bank, is the Mortgage Bank of Uruguay, whose purpose is focused on savings and mortgage financing (which is why it is not included in the following analysis).

The Uruguayan banking system, like other countries in the region, is characterized by its high banking concentration. In this regard, in December 2013, BROU channeled 45.5% of the total turnover, while the four largest private banks: Santander, Itaú, BBVA and NBC, accounted for 42.9% of the total turnover. Therefore, the 5 largest institutions of the system concentrated 88.4% of the total turnover.

Graph 31– Turnover, Bank Market Share
(December 2013)

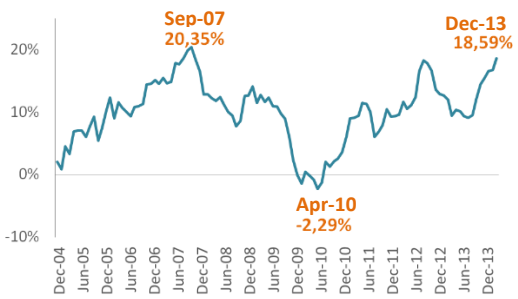


Source: UCB

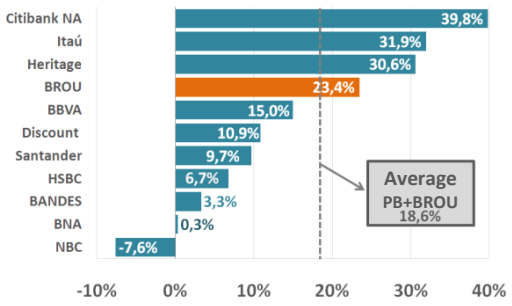
Profitability and Efficiency

In terms of profitability, in the last ten years the Uruguayan financial system experienced three major trends. In the beginning of said period and until the end of 2007, the profitability of the system showed a positive trend, consistent with the recovery from the crisis of 2002. Then until April 2010, a period of decline was noted, exacerbated by the effects of the 2008 international and because of Uruguayan bank's open foreign currency position. Finally, in the last period the situation improved and the Uruguayan banking system recovered historical high levels of performance (in late 2013, the annual results in terms of system-wide assets amounted to 18.59%).

Graph 32 – ROE Financial System



Graph 33 – Ranking ROE by institution
(December 2013)



Source: CBU

At present, most banking institutions showed positive accumulated annual earnings. As can be seen in Graph 31 In December 2013, Citibank and Itau were the banks with larger ROE in the system, recording values of 39.8% and 31.9% respectively. Meanwhile, which NBC is one of the largest banks, is also the only institution that had a negative ROE (7.6%).

However, the profitability of the financial system should be taken as a challenge to face, because of its unsatisfactory levels when compared with other banks in the region.[11]

Reflexions of the Uruguayan financial system

In short, low credit penetration in the economy, scarce depth, a low level of development of services and relatively low levels of profitability and efficiency of the banking institutions have hindered the banking system's evolution in spite of the local economy's dynamism.

The strength of the financial system has increased in the last decade and is at acceptable levels, with low levels of risk, process which has been accompanied by changes in the composition of sales, a decrease of the dollarization, an increase of regionalization and an increase in business concentration.

However, the relatively low profitability in the region has resulted in the intention of some banks to leave Uruguay. This scenario could represent an opportunity in the redesigning of business, changing the concept of the current banking business and transforming banks in financing platforms for the real sector of the economy. In particular, Uruguay seems to be able to offer a good platform for a financial institution as a basis for business development throughout the region.

[11] Annex 8

IV.3 Advantages for the establishment of regional business

In regard to the possibility of regional business development using Uruguay as a platform, the following chapter will analyze some of the main advantages and systems that Uruguay offers in order to attract investments for different purposes. Particularly, this chapter will analyze: i) The Free Trade Zone scheme, ii) Law of Investment Promotion, iii) Free Port scheme and iv) Public-Private Participation scheme.

i) Free Trade Zone scheme

General

Free Zones are duly isolated public or private areas within national territory that enjoycertain tax exemptions and other benefits specified by law, for the purpose of engaging in all types of industrial, commercial and service activities, including:

(a) Commercialization of goods, warehousing, storage, preparation, conditioning, selection, classification, division, assembly, disassembly, handling or mixing of merchandise or raw materials of national or foreign origin;

(b) Installation and operation of manufacturing establishments;

(c) Provision of all types of services not restricted by national rules, both within free zones and from them to third party countries

(d) Other activities, including banking activities, approved by the Executive branch.

Free Zone Users

Free Zone Users are individuals or legal entities who acquire the right to engage in any of the activities included in the Free Zone regimen in such areas.

To enjoy the tax benefits afforded by the free trade zone regime it is necessary to establish or acquire a free zone company and obtain user status.

Although the law provides for two categories of users (direct and indirect), it does not establish differences as to the benefits and tax exemptions, or as to the legal obligations corresponding to each of them. Direct users acquire the right to operate in a Free Zone by means of a contract signed with the Free Zone operator. Indirect users acquire the right to operate in a Free Zone by means of a contract signed with a direct user.

a. Obtaining user status

Once a free zone company has been acquired it must arrange a direct or indirect user contract, which is to include the conditions for setting up business and must be approved by the General Office of Trade - Free Trade Zones Area. To obtain approval of the contract it is necessary to

file a detailed description of the activity to be undertaken, business and investment plan, and list of personnel hired.

The Free Zones Area of the General Office of Trade will authorize direct or in-direct user contracts when the information included in the business plan clearly shows that the company will perform the activity covered by the contract from the free trade zone, contributing to fulfillment of the objectives set forth in the Free Trade Zone Law.

Such requirements will be understood to have been met when the contract and the business plan unequivocally show that the planned activity simultaneously meets the following minimum conditions:

(i) General direct or indirect employment in the free zone;

(ii) Activity to be conducted in free zone, using or taking advantage of facilities provided by the operator or direct user, as applicable;

(iii) Tax domicile is in free zone.

b. User Contract Terms

Depending on the type of contract signed and the activity to be performed, this is the term that the Government guarantees for operation as a free zone user.

The maximum term for direct user contracts is 10 years for commercial, offshore commercial and service activities, and 15 years for industrial activities. The maximum term for indirect users is 5 years in all cases.

In any event, prior to the contractual term expiration, the user can request the Free Zone for an extension of the user contract, in which case it will be necessary to present a new business and investment plan. Subsequent extensions can be requested, but the duration of each extension cannot exceed the original term of the contract.

Tax exemptions and other benefits

Merchandise entering or leaving Free Zones from or to any third party country are not subject to customs duties or taxes. Free Zones are not subject to current or future requirements regarding obligatory inclusion of local components in manufactured goods, or other limitations with respect to entry or exit of goods from Free Zones, with the exception of those relative to control. Moreover, there legally-protected full freedom for entry and exit from Free Zones of securities, national and foreign currencies, and precious metals for any purpose, and the holding, sale, circulation and conversion or transfer thereof.

Legal monopolies granted to industrial and commercial utilities (electricity, fuels, communications, insurance) are not applicable in Free Zones. Additionally, government corporations providing inputs or services to Free Zone users may establish special promotional rates.

Free Zone users also benefit from a generic exemption from all current or future taxes on companies or sole proprietorships, with respect to activities performed in Free Zones. The government guarantees by law, under liability for damages, the maintenance of all tax exemptions and other benefits during effectiveness of the user contract.

Exoneration does not cover special Social Security contributions for Uruguayan personnel. Foreign personnel working in Free Zones do not have to make Social Security contributions if they opt out of the Uruguayan system in writing.

The main taxes covered by this exemption are the Business Income Tax (except as indicated above), Net Worth Tax, Corporate Organization Tax, Value Added Tax, Excise Tax (IMESI), and Tax on Purchases of Foreign Currency.

Restrictions

Companies established in Uruguayan Free Zones may export to any destination, including the MERCOSUR countries. Nevertheless, exports to MERCOSUR countries are treated as imports to third party countries (that is, non- MERCOSUR countries), and consequently are subject to the Common External Tariff. Additionally:

(a) Companies set up in Free Zones cannot engage in industrial, commercial or service activities in non-free Uruguayan territory.

(b) A minimum of 75% of the persons employed by a company in Free Zone activities must be native or naturalized Uruguayan citizens in order to maintain Free Zone user status and the exemptions, benefits and rights granted by law. This percentage may be reduced upon Executive Branch authorization.

The preferential treatment granted to Uruguayan exports by other countries in relation to certain products or for limited volumes or quantities will be applied preferentially to industries exporting such products and already operating in non-free zones.

i) Free Port.[12]

One of the advantages of Uruguay as a logistic hub for Mercosur is the Free Port scheme in the ports of Montevideo, Nueva Palmira, La Paloma and Fray Bentos and Sauce. In effect, the Port of Montevideo was the first Free Port of the South American Atlantic Coast and nowadays is the only free port in the Southern Cone.

Operating under the free port scheme offers advantages in the logistic operations of a country. On one hand, concerning port operations, the free port scheme allows overseas vessels to

[12] http://www.uruguayxxi.gub.uy/exportaciones/centro-de-informacion/incentivos-para-la-exportacion/
http://www.mef.gub.uy/unasep_puerto_libre.php

enter the goods to a port without any formal proceedings. Moreover, while the goods are in the port several activities may be undertaken to add value without modifying the nature of the goods.

The allowed activities may be to modify the presentation or destination of the merchandise. On the other hand, in addition to the conventional activities: loading, unloading, stowage and transport, the following activities are also allowed: repacking, reframing, classifying, grouping and regrouping, consolidating, handling and fractioning, transfer, reembarking, transit, removal, deposit, storage, rearrangement, supplying vessels, ship repair and other services related to port activities.

In this way, the possibility of a transfer allows the free port to operate in a much superior scale favoring merchandise transfers to upstream destinations such as Paraguay, Eastern Argentina, Southern Brazil and Northern Uruguay.

While the merchandise is in the port the goods are exempt of any customs duties, such as the Value Added Tax (VAT) and they will be excluded from the calculation of the Wealth Tax. On the other side, there is no time limit on the amount of time that the goods may remain in the port. In effect, the merchandise will be considered imports once they leave the port and enter national customs territory and the corresponding scheme will be applied. Moreover, an export will be considered effective once the merchandise leaves customs territory and enters the port.

In addition to the ports previously mentioned, several “extra-port terminals” have been created. Given the increasing flow of merchandise in the Uruguayan ports (mainly Montevideo and Nueva Palmira), these terminals have been installed in order to eliminate congestion of merchandise in the limited space that the ports offer and favor the normal circulation of goods.

ii) Description of PPP scheme.

The Public-Private Participation (PPP) scheme is a procurement system between a Public Administration (contracting party) and the private sector (contractor) where the contracting party hires the contractor to design, build and/or operate the infrastructure, in addition to funding it.

Driven by the Law N° 18.786 from July 19th, 2011, the Uruguayan state defined the applicable regulatory framework for the Public-Private Participation scheme contracts, a tool which will be used in order to cater for the most pressing demands of infrastructure that the country is facing. Given that the conventional tender methods have proven to be inefficient to cater for these means, a tool was created for roadwork, port, airport and railway infrastructure, waste treatment, power generation, prisons, health-care centers, education centers and public housing.

In respect to the provision of services, the provision of educational services is not allowed when they are undertaken in educational centers, sanitary services are not allowed either

when they are undertaken in health-care centers and safety, health services and reeducation of prisoners are not allowed when they are undertaken in prisons.

The first step in the procurement procedure is to start the ex officio proceedings, through a public initiative or a private initiative presented to the National Corporation for Development (NCD). Later, the evaluation of the project must be taken forward, considering its feasibility and convenience. Also, the proposed procurement plan must be demonstrated as the plan that allows the state to obtain the best value for money. These evaluation analyses must be presented to the Planning and Budget Office (PBO) for their consideration. Once the report from the PBO is obtained, the Public Administration (contracting party) will develop the contracting terms and conditions and the contract draft which will be presented to said entities. The contracting public administration may employ any competitive method (including bids and auctions) for an open tender. In the event of more complex projects a tender called "competitive dialogue"[13] may be applied. Later, the proposals will be presented and these will proceed to the examination stage. Once the proposals are examined, a preference order will be formulated considering the different assessed criteria.

Nowadays, under this law, projects have been presented for up to USD 2.5 billion. Said projects are currently in different stages of development and different levels of progress. Within the projects that are currently in their final stage of contracting, there is a project that was tendered for the design, construction, equipment and funding of a new penal institution for approximately 2,000 inmates.

On the other hand, there are several open projects. Such as a project that is being tendered for the design, construction, financing, operation and transfer of a National Highway Network where the initial investment was USD 165 and 235 million. An open tender is being held for this project.

Another project that is still in the first stages of development is a deep water port in the Atlantic Coast of Rocha, Uruguay. The authorization for the construction is already established in the Law N° 19.046 approved by the Parliament in January 2013, in which the place for its installation was determined. The investment for the development of the deep water port is estimated to be approximately USD 1 billion and there are now 40 companies from the construction, port operation, logistic and maritime transport sectors from Argentina, Brazil, Chile, Uruguay, Venezuela, Belgium, Spain, France, Italy, The Netherlands, Greece and The United States interested in the project.

Furthermore, catering for the importance of the railway sector development mentioned previously, within the projects that are being executed there is a project underway for the Algorta and Fray Bentos railway line rehabilitation with an estimated initial investment of USD 90 to 100 million. At the moment, a tender is being drawn up and its technical part is in an

[13]This is a new development with respect to the current legislation which consists in the dialogue of all aspects of the PPP contract, between the administration and the applicants that participated in the tender and meet the technical and economic solvency requirements.

advanced stage of progress. Within the framework of a railway reform there are several other rehabilitation and remodeling projects in progress that are in early stages awaiting their development under this program.

iii) Law of Investment Promotion

The current scheme for General Investment Promotion and Protection promotes the development of productive investments in the country, granting tax benefits and demanding (in addition to the execution of the investment) certain commitments with respect to specific objectives to be reached on behalf of the investing companies: employment generation, contribution to decentralization, increase in exports, clean production, investment in research and development. The compliance of these objectives will be assessed and a score will be designated, the project must obtain at least one point in the total weighed score.

Business Income Tax (BIT) taxpayers may also have access to the benefits of this scheme, regardless of their legal status and investment levels, said projects will be promoted by the Executive Branch. Additionally, investments made six months before the start of the project are also included in this scheme, for instance: purchase of goods to be used in the production cycle, improvements of facilities, among others.

Benefits include: exemption of Business Income Tax (BIT) with respect to the investment, exemption of the Wealth and import taxes in the purchase of fixed assets and reimbursement of the Value Added Tax (VAT) while purchasing building materials. There are also specific schemes that may be applied for companies that are part of a particular field of activity.

V. ANNEXES

V.1 Institutionalization in the Mercosur

The evolution of the bloc has not been given only in terms of new accessions and additions, but also over the years its organizational structure has undergone changes. Expansion of its members and partners should be followed by an institutionalization aligned with an increasing rate of issues and the various circumstances that it may be confronted in its growth.

It is important to analyze that the institutionalization of the bloc, since it has often marked the overall development of the bloc itself, and particularly the negotiations and approaches made by its different members.

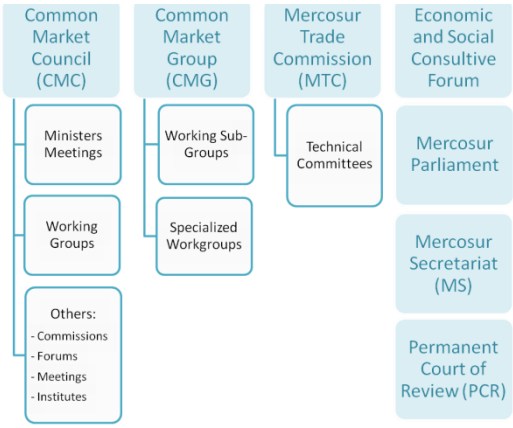
The institutional structure of the Mercosur, embodied in the Ouro Preto Protocol, is characterized by a significant concentration of power in the decision-making bodies, which, because the bloc does not have supranational bodies, are linked to the executives of the Member States. Through these institutions even regular administrative procedures pass and this, in addition to not having a definite and permanent formation, makes it difficult for the institutions to develop a comprehensive vision of the regional situation.

The Common Market Council (CMC), the Common Market Group (CMG) and the Mercosur Trade Commission (MTC) are decision-making bodies.

The decisions in the organs are made by consensus and with the presence of all Member States. While votes against are not allowed, this consensus does not imply unanimity, since abstentions allowed.

In turn, it is important to note the great influence of the country to which corresponds the Pro Tempore Presidency (PTP), which is who governs the pace of meetings and resolutions made in the period. The PTP rotates every six months among member countries in alphabetical order.

Illustration 3 – Institutional structure of MERCOSUR



Other institutions that comprise the bloc are the Mercosur Parliament, the Economic and Social Consultative Forum, the Mercosur Secretariat (MS), Mercosur Secretariat with permanent headquarters in Montevideo, and the Permanent Court of Review (PCR), the latter created by the Olivos Protocol for the settlement of disputes. In turn, there are several spaces for negotiation on several aspects, which inform the decision-making bodies all issues treated semiannually.

In conclusion, the close ties of the bloc's decision-making bodies to the members' executives, in addition to their concentration of power and lack of a permanent structure, has been an obstacle to the development of an integrating vision of all the institutions that are part it.

Nonetheless, the result of negotiation between the Mercosur members through their institutions have established various agreements concerning issues of interest not only economic but also social, political, environmental, etc..

Among them, issues concerning the existent asymmetries in the bloc have been treated, such as the levels and the structure of the Common External Tariff, the convergence rate of the partners at the same time, the need for an origin regime, the elimination of double charging of this fee, the creation of a Structural Convergence Fund Mercosur (SCFM), the establishment of a Payment System in Local Currency, among others.

V.2 Regulatory aspects of the extended market agreement.

Regardless of the development degree of the Mercosur agreements, it is interesting to review some of the main provisions. In this sense, although there are various rules related to the membership of one country in the bloc, three of them are particularly interesting to analyze: i) Common External Tariff, ii) MERCOSUR Origin Regime and iii) Payment Systems in Local Currency.

ii) Common external tariff

Since the establishment of the bloc as a Customs Union in 1995, a Common External Tariff (CET) was adopted, which establishes the tariff payable on imported goods from countries outside the economic bloc.[14]

The AEC aliquots range from 0% to 35% being the higher value added products that are produced in the region and are generally taxed at higher tariff levels, in order to promote the regional industry by replacing importation of these products manufactured from extra-area.

There are also exception lists for each member of the bloc, containing a certain amount of items to which the AEC does not apply. The current lists in force correspond to 100 NCM codes for Argentina and Brazil, 225 codes for Uruguay and 649 codes for Paraguay.

In addition to these exceptions, there is additional legislation by which certain products (belonging to the automotive and textile sectors, as well as the sugar industry, information technology and telecommunications, capital equipment, among others) are not covered by the AEC.In the same way, it is possible to manage the specific tariff reduction on certain products for a maximum period of twelve months, in order to ensure normal supply to the Mercosur, where importation is not viable due to external reasons.

iii) MERCOSUR origin regime.

To the extent that there are holes on the Common External Tariff, which may impede the free trade of goods within the bloc, it is necessary to adopt an origin regime in order to ensure the origin of exchanged goods and establish clear rules to facilitate trade between the Mercosur members.

In response to this, the Mercosur Origin Regime (MOR) was established, as a transitional measure until 2016, inclusive, which exempts from tariffs goods imported from any of the member states.

[14] The system is base on the Mercosur Common Nomenclature (NCM), which falls within the Harmonized Designation System and Goods Codification created by World Customs Organization (OMA). The NCM comprises 99 chapters within 21 sections, in detail with 8 digits.

In order to request the application of ROM, producer of goods must submit an Affidavit of Origin, an Affidavit of Use of Materials, and a corresponding Certificate of Origin issued by one of the qualified entities. Two rules are generally established for the implementation of ROM when used in the production of input goods not originating from the Mercorsur Member States. On the one hand, if the manufactured good has a tariff different from the tariff applied to its inputs originating from outside the bloc, i.e. it acquires a new individuality from a transformation process performed in a Member State and, on the other hand, in case the product is traded within the members of the bloc, the value of the imported inputs used in the production of the manufactured product does not exceed 40% of the value of the manufactured good.

There is legislation that expands this Regime in order to include products for which inputs from outside the bloc were used in certain conditions, products subject to manufacturing processes in more than one member country, and products stored in customs warehouses from one of the Member States, including the possibility to designate to one of the Member States a fraction of the stored goods.

In order to be applicable the possibility of designating to a Member State a share of the total of goods stored in a customs' warehouse, it is necessary to obtain a Certificate of Origin resulting from the certificate that followed the merchandise once it entered the warehouse.

iv) Payment system in local currency (PSLC)

In addition to seeking harmonization of nomenclature and tariffs applied to trading between the Member States and among them and the rest of the world, its facilitation was also expected by promoting the use of local currencies of the countries in the transactions made within the bloc.

This is how a transactions and payment system in local currency was approved for both commercial operations and of any other nature between the Mercosur countries. Two purposes were achieved with this mechanism: on the one hand, to speed up the commercial operations and, on the other hand, the access of agents to more favorable quotation, reducing the financial costs.

Studies performed before the implementation of the system.

The first countries to show interest in implementing this system were Argentina and Brazil. In 2005, the central banks of both countries undertook studies on international experiences of similar mechanisms, as well as highlighted the multiple benefits of achieving its implementation in the region.

Mainly because of the existing trade between their economies, the number of agents that have access to it, and especially because of the implications of the system with respect to the

reduction of transaction costs, financial and administrative. In particular, this would be an advantage for small operators since their participation may be encouraged by bilateral trade, in turn progressing toward integration in order to ensure that the agents have a greater approach to the use of local currencies and have greater participation in the foreign exchange market.

It was estimated by the authorities that savings costs generated by the system would reach 4%, and that it would capture an approximate share of 10% to 20% in bilateral trade operations.

Since the beginning certain desirable conditions were raised regarding the establishment of the system and the clearing of exchange between countries. It was perceived to be a system of voluntary and complementary participation payment systems already available, and it was desirable that the system had no credit risk or foreign exchange risk for the participating institutions, and the lack of accountability of central banks was established in the case of possible controversies. Central banks play the role of intermediaries in the transactions between operators.

In 2006, several meetings with private operators and banks in both countries took place, the required legislative changes for the system's implementation were analyzed, technological tools needed to integrate the same payment systems were deployed in each country and the terms of the agreement to create clearing houses were established, among other aspects.

Special emphasis was placed on the need to avoid exposure of the central banks to risks arising from the various foreseeable contingencies in the operation of the system and to develop action procedures in each case.

Central banks were given the possibility of suspending the implementation of the system in case of adverse situations that affect or substantially change the conditions for an adequate functioning. As well as the possibility of changing the regulation in the case that both parties reach an agreement.

In order to preserve the credibility of the system in the case of possible contingencies, a "margin of contingency" was created in case there were errors or differences in daily compensation payments, enabling the payment of deferred balances through the payment of interests (LIBOR + 1%) as a way to discourage their use.

When the system was applied, with a previous test stage, different measures were approved in order to encourage participation of smaller commercial operators. For instance, an approved measure was to eliminate certain documentation in transactions made with smaller amounts.

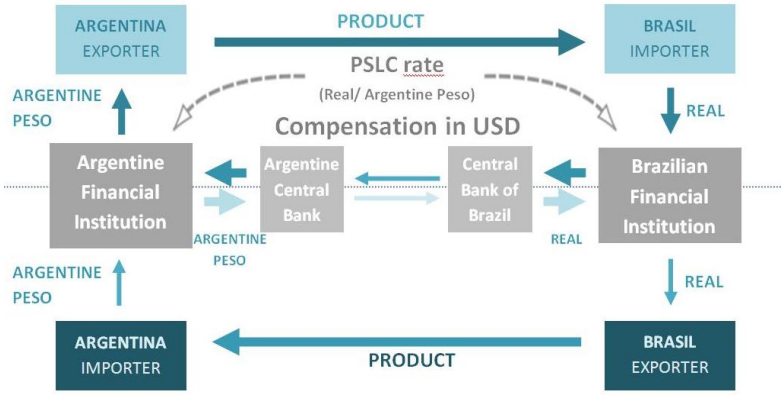
Operating system

In effect, it is a system of compensation and transfer. Daily rates are set, compensating unilateral balances recorded in the central banks of each country, resulting from transactions made in the day and made through authorized entities. Importers and exporters make

payments and collections in their own currency without resorting to the foreign exchange market because the central banks are responsible for the exchange rate market and they close the balances in dollars.

The system works with exclusively goods commercial operations of up to 360 days. There are no restrictions on the products included in the transaction nor a minimum or maximum amount for payments made through the local currency payment system. The payment for the exporter will be available on the second business day after the operation is recorded by the importer.

Illustration 4 – Summarized Procedure of the Local Currency Payment System



Information released by the Central Bank of Brazil shows a persistent increase in both the amounts and the transactions made through the SML, mainly because of the use given by exporters.

However, the total amount of transactions channeled through this system amounted to 3% of total trade in goods between Brazil and Argentina, this percentage is higherin the case of Brazilian exports to Argentina: 6%.

Uruguay has begun the process of system implementation and has completed the signing of letters of intent with both Brazil and Argentina.

Table 5 – Operations between Argentina and Brazil within the SML
(Brazilian Exports+Imports to Argentina)

Year	EXPORTS		IMPORTS		Total	
	Number of operations	Amount (USD thousand)	Number of operations	Amount (USD thousand)	Number of operations	Amount (USD thousand)
2009	*1.193*	*32.035*	*73*	*2.158*	***1.266***	***34.193***
2010	*3.410*	*678.526*	*41*	*5.060*	***3.451***	***683.585***
2011	*4.973*	*982.605*	*50*	*5.232*	***5.023***	***987.836***
2012	*7.444*	*1.170.249*	*83*	*8.844*	***7.527***	***1.179.093***
2013	*9.067*	*1.195.933*	*47*	*4.873*	***9.114***	***1.200.806***

Source: Central Bank of Brazil

Concepts and key definitions of the system

Central Banks – Signatory institutions of the Local Currency Payment System Agreement between Argentina and Brazil.

Compensation - Act or effect of compensating unilateral central bank balances, by obtaining the difference between unilateral balances.

Local Currency Payment System Agreement - The agreement signed by the BCB and BCRA laying down general rules for the performance of each of the central banks in the SML.

Correspondent - The financial institution designated by each central bank to make the transfer of the Bilateral Balance or debt from one central bank to the other, derived from their participation in the Convention.

Authorized Entity/Entities – Matrixes, branches or subsidiaries of commercial banks and financial institutions authorized by central banks in their respective areas of competence, to operate in the SML.

Eventual or Contingency Margin - Operating limit that central banks establish to allow deferred payment of the bilateral balance.

Bilateral Balance - The difference resulting from the financial compensation of unilateral amounts, i.e.: the sum of the values of the transactions that are made by SML on a particular day in the currency that was originally recorded by the importer, converted to dollars at the corresponding change rate.

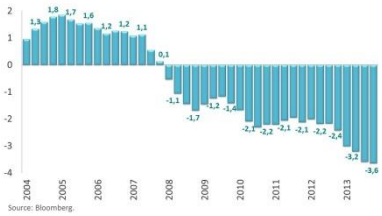
PSLC – Payment system in local currency between Brazil and Argentina, created by the CMC Decision N° 25/07.

Transfers –Transfers made in dollars by the Correspondent(s), destined to pay the Bilateral Balance.

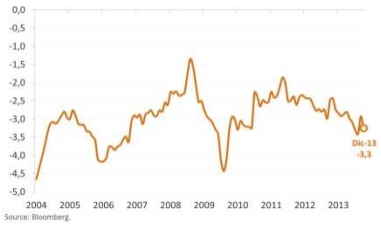
V.3 Macroeconomic variables

Brazil

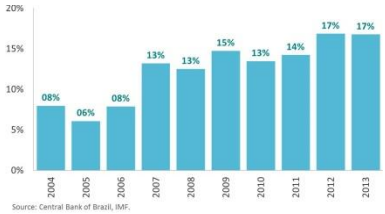
Graph 34 – Current Account Balance (Brazil)



Graph 35 – Overall Balance of the Public Sector (Brazil)

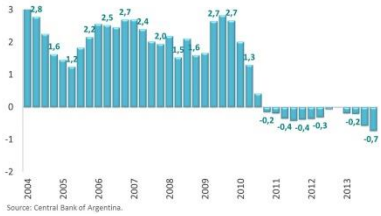


Graph 36 – International Reserves (Brazil)

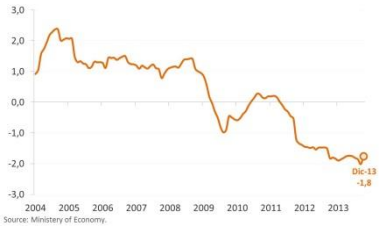


Argentina

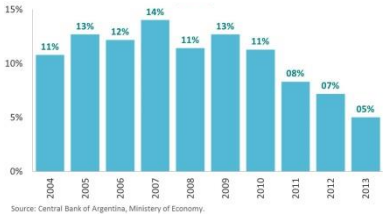
Graph 37 – Current Account Balance (Argentina)



Graph 38 – Overall Balance of the Public Sector (Argentina)

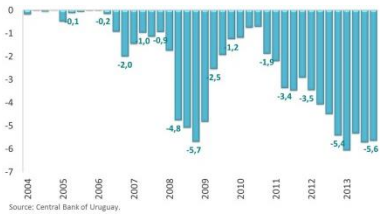


Graph 39 – International Reserves (Argentina)

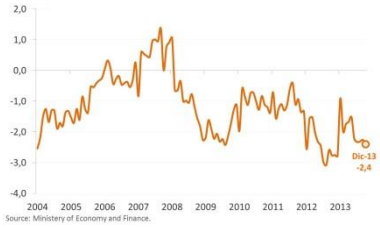


Uruguay

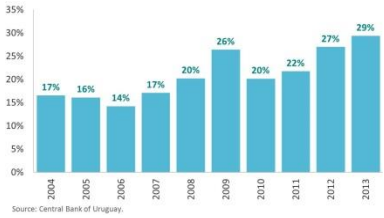
Graph 40 – Current Account Balance (Uruguay)



Graph 41 – Overall Balance of the Public Sector (Uruguay)



Graph 42 – International Reserves (Uruguay)



V.4 External trade statistics

Extra-bloc trade

Table 6 – Exports of goods outside MERCOSUR by country, 2013
(USD thousand)

Country	Argentina	Brazil	Paraguay	Uruguay	MERCOSUR
China	5.510.627	46.026.153	57.107	1.291.008	**52.884.895**
United States of America	4.289.600	24.865.953	251.417	355.587	**29.762.557**
Netherlands	1.912.585	17.325.880	74.743	203.987	**19.517.195**
Japan	1.390.678	7.964.031	83.924	11.528	**9.450.161**
Chile	3.906.689	4.483.783	525.833	143.452	**9.059.757**
Germany	1.637.388	6.551.654	334.848	314.914	**8.838.804**
Venezuela	2.155.636	4.849.840	51.724	446.588	**7.503.788**
Republic of Corea	1.002.347	4.719.970	51.650	23.567	**5.797.534**
Mexico	1.063.993	4.230.301	272.101	145.989	**5.712.384**
Italy	1.080.770	4.098.143	325.228	145.436	**5.649.577**
Spain	1.717.639	3.575.966	223.492	107.107	**5.624.204**
Russia	725.829	2.974.145	946.822	278.808	**4.925.604**
United Kingdom	645.918	4.101.835	28.761	86.572	**4.863.086**
Panama	113.490	4.423.187	4.354	11.786	**4.552.817**
Canada	1.702.854	2.701.746	6.596	54.510	**4.465.706**
Others	26.211.957	69.544.716	2.378.405	1.638.256	**99.773.334**
Total	**55.068.000**	**212.437.303**	**5.617.005**	**5.259.095**	**278.381.403**

Source: Trademap.

Table 7 - Exports of goods outside MERCOSUR by product, 2013
(USD thousand)

Product code	Product label	Argentina	Brazil	Paraguay	Uruguay	MERCOSUR
26	Ores, slag and ash	1.364.806	34.111.366	2	840	**35.477.014**
12	Oil seed, oleagic fruits, grain, seed, fruit, etc, nes	4.564.301	23.012.832	2.443.594	999.037	**31.019.764**
23	Residues, wastes of food industry, animal fodder	11.909.405	7.071.545	847.329	25.601	**19.853.880**
2	Meat and edible meat offal	1.804.914	14.656.662	946.940	1.376.769	**18.785.285**
27	Mineral fuels, oils, distillation products, etc	2.434.269	16.247.569	19.499	13.705	**18.715.042**
10	Cereals	7.295.008	7.025.626	327.184	468.717	**15.116.535**
17	Sugars and sugar confectionery	206.334	11.934.298	75.687	5	**12.216.324**
84	Machinery, nuclear reactors, boilers, etc	963.823	10.404.853	15.459	16.059	**11.400.194**
89	Ships, boats and other floating structures	50.326	7.933.150	12.155	7.368	**8.002.999**
72	Iron and steel	133.772	7.624.393	15.192	648	**7.774.005**
15	Animal,vegetable fats and oils, cleavage products, etc	5.091.241	1.805.489	335.373	59.073	**7.291.176**
87	Vehicles other than railway, tramway	1.803.769	4.546.961	495	6.946	**6.358.171**
71	Pearls, precious stones, metals, coins, etc	2.053.389	3.274.964	33.942	115.635	**5.477.930**
47	Pulp of wood, fibrous cellulosic material, waste etc	22.271	5.166.773	161	693	**5.189.898**
88	Aircraft, spacecraft, and parts thereof	779.121	4.290.962	93	113	**5.070.289**
	Other products	14.591.251	53.329.860	543.900	2.167.886	**70.632.897**
	TOTAL	**55.068.000**	**212.437.303**	**5.617.005**	**5.259.095**	**278.381.403**

Source: Trademap.

Table 8 – Imports of goods outside MERCOSUR by country, 2013
(USD thousand)

Country	Argentina	Brazil	Paraguay	Uruguay	MERCOSUR
China	11.243.312	37.302.150	3.434.089	1.965.195	**53.944.746**
United States of America	8.024.780	36.280.346	795.103	1.012.355	**46.112.584**
Germany	3.874.067	15.182.003	236.382	294.112	**19.586.564**
Republic of Corea	1.233.220	9.491.256	243.609	220.455	**11.188.540**
Nigeria	256.342	9.647.535	-	583.075	**10.486.952**
Japan	1.515.734	7.081.665	278.368	93.840	**8.969.607**
France	2.062.944	6.509.359	108.447	240.614	**8.921.364**
Italy	1.655.192	6.724.125	79.630	193.318	**8.652.265**
Mexico	2.154.190	5.794.778	169.353	298.584	**8.416.905**
India	772.267	6.357.300	95.602	160.189	**7.385.358**
Spain	1.364.688	4.486.374	113.111	195.083	**6.159.256**
Bolivia	1.731.261	3.937.744	43.933	11.999	**5.724.937**
Chile	964.971	4.328.270	148.607	152.224	**5.594.072**
Russia	1.717.370	2.676.066	212.611	141.065	**4.747.112**
United Kingdom	580.112	3.614.591	61.024	163.908	**4.419.635**
Others	13.136.785	59.486.739	1.038.516	2.244.876	**75.906.916**
Total	**52.287.235**	**218.900.301**	**7.058.385**	**7.970.892**	**286.216.813**

Source: Trademap.

Table 9 – Imports of goods outside MERCOSUR by product, 2013
(USD thousand)

Product code	Product label	Argentina	Brazil	Paraguay	Uruguay	MERCOSUR
27	Mineral fuels, oils, distillation products, etc	10.122.526	43.912.678	697.719	1.900.963	**56.633.886**
84	Machinery, nuclear reactors, boilers, etc	8.467.245	34.634.542	1.114.468	1.046.659	**45.262.914**
85	Electrical, electronic equipment	7.454.607	28.052.078	1.684.464	836.515	**38.027.664**
87	Vehicles other than railway, tramway	5.391.317	14.176.416	848.948	807.505	**21.224.186**
29	Organic chemicals	2.622.533	10.570.227	171.114	237.373	**13.601.247**
39	Plastics and articles thereof	1.862.479	7.882.839	150.685	348.435	**10.244.438**
31	Fertilizers	820.149	8.839.339	148.314	304.670	**10.112.472**
30	Pharmaceutical products	1.993.932	7.230.947	112.171	152.485	**9.489.535**
90	Optical, photo, technical, medical, etc apparatus	1.475.348	7.050.478	113.647	139.683	**8.779.156**
38	Miscellaneous chemical products	1.277.039	4.557.439	199.846	190.258	**6.224.582**
40	Rubber and articles thereof	848.779	4.371.411	163.376	179.395	**5.562.961**
73	Articles of iron or steel	842.583	4.421.907	41.599	110.352	**5.416.441**
72	Iron and steel	483.699	3.053.018	79.720	107.341	**3.723.778**
88	Aircraft, spacecraft, and parts thereof	533.811	2.691.602	27.905	29.489	**3.282.807**
28	Inorganic chemicals, precious metal compound, isotopes	460.043	2.236.246	13.666	36.982	**2.746.937**
	Other products	7.631.145	35.219.134	1.490.743	1.542.787	**45.883.809**
	TOTAL	**52.287.235**	**218.900.301**	**7.058.385**	**7.970.892**	**286.216.813**

Source: Trademap.

Table 10 – Exports from MERCOSUR to Russia by product, 2013
(USD thousand)

Product code	Product label	MERCOSUR
020230	Bovine cuts boneless, frozen	**1.840.202**
170114	Raw cane sugar, not containing added flavouring or colouring matter (excl. 1701 13)	**593.489**
120190	Soya beans, whether or not broken (excl. seed for sowing)	**407.053**
020329	Swine cuts, frozen nes	**376.699**
240120	Tobacco, unmanufactured, partly or wholly stemmed or stripped	**164.305**
020714	Fowls (gallus domesticus), cuts & offal, frozen	**150.357**
040510	Butter	**103.218**
080830	Pears	**91.987**
210111	Coffee extracts, essences, concentrates	**87.745**
090111	Coffee, not roasted, not decaffeinated	**58.361**
	Other products	**1.052.188**
	TOTAL	**4.925.604**

Source: TRADEMAP

Intra-bloc trade

Moreover, if intra-bloc trade is analyzed, it is possible to determine that trade flows to the region are asymmetric for the different countries. Historically, small economies (Uruguay and Paraguay) were those with a greater dependence on the bloc, represented as the percentage of exports to intra-regional trade. This reality is reflected in the decisions and the position of each member with respect to the policies of the bloc. In recent years Uruguay has managed to diversify its export destinations, which has resulted in less dependence of the bloc, reaching levels similar to Argentina.

Table 11 – Total trade (exports+imports) of goods for each country within MERCOSUR and percentage of total trade, 2013
(USD thousand)

		2009	2010	2011	2012	2013
Argentina	total trade	*26.733.529*	*36.134.673*	*44.048.779*	*38.788.119*	*39.452.659*
	% dependence	***28%***	***29%***	***28%***	***26%***	***26%***
Brazil	total trade	*29.139.601*	*39.878.880*	*47.971.981*	*42.052.120*	*43.953.062*
	% dependence	***10%***	***11%***	***10%***	***9%***	***9%***
Paraguay	total trade	*4.349.511*	*6.970.815*	*8.475.451*	*8.333.973*	*8.892.857*
	% dependence	***43%***	***42%***	***42%***	***44%***	***41%***
Uruguay	total trade	*4.659.652*	*5.264.277*	*6.574.038*	*6.273.827*	*5.995.947*
	% dependence	***38%***	***34%***	***35%***	***31%***	***29%***

Source: TRADEMAP

The extra-bloc trade with minority partners today represents a higher proportion than years ago. However, intra-bloc trade has the peculiarity that certain sensitive products are only competitive at the level of intra-Mercosur trade, and because of this extra-bloc is highly restricted. Some examples are the textile industry or energy production Uruguay in Paraguay, whose product, albeit for different reasons, can only be sold within the bloc. This peculiarity of certain exports also applies to the import trade of some products, which by their nature or because of their cost can only be acquired within the bloc.

Table 12 – Uruguay's export details by Product – dollars (2013)

Position	Product	Total FOB	% FOB
1201900000	Soybean	1,867,482,240	20.50%
0202300069	Beef - Pieces of hindquarter, frozen, boneless	351,334,208	3.90%
1006302110	Rice - Polished, Milled or wholly milled - no parboiled	348,649,280	3.80%
0402211000	Milk - Full cream	339,274,784	3.70%
4403990010	Wood - Eucalyptus, roughed, or roughly squared	324,238,240	3.60%
0201300049	Beef - Pieces of hindquarter, chilled, boneless	316,074,496	3.50%
1001990010	Wheat	296,072,352	3.20%
0202300050	Beef - Pieces of forequarter, frozen, boneless	267,444,464	2.90%
1107101010	Barley - whole or split unroasted	210,378,816	2.30%
0406902000	Cheese - With moisture between 36,0% and 46%	175,116,816	1.90%
-	Others	4,613,603,847	50.70%
TOTAL		9,109,669,543	100%

Source: Trademap

Table 13 – Uruguay's export details by Companies – dollars (2013)

Companies	Total FOB	% FOB
CONAPROLE (Milk)	585,305,536	6.4%
CARGILL (Crops)	420,090,336	4.6%
CEREOIL (Crops)	325,493,056	3.6%
BARRACA ERRO (Crops)	287,733,664	3.2%
LOUIS DREYFUS COMMODITIES (Crops)	268,277,360	2.9%
UPM FORESTAL ORIENTAL (Wood)	243,049,904	2.7%
SAMAN (Rice)	232,504,992	2.5%
GARMET (Crops)	166,538,112	1.8%
FRIGORIFICO LAS PIEDRAS (Beef)	137,097,584	1.5%
KILAFEN (Crops)	135,980,944	1.5%
Others	6,307,598,055	69.2%
TOTAL	9,109,669,543	100%

Source: Trademap

Table 14 – Uruguay's export details by Destination – dollars (2013)

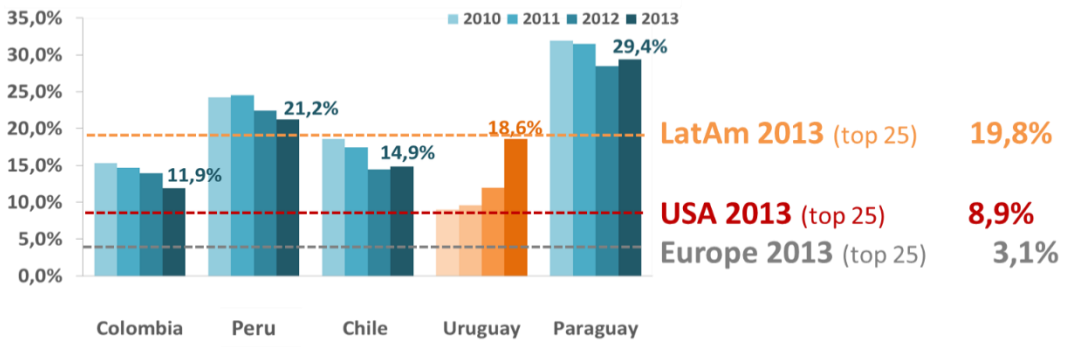
Destino	Total FOB	% FOB
BRAZIL	1,757,821,952	19%
CHINA	1,489,574,016	16%
Free Zone NUEVA PALMIRA (URUGUAY)	724,846,208	8%
ARGENTINA	472,665,728	5%
VENEZUELA	449,072,320	5%
GERMANY	362,140,320	4%
UNITED STATES	356,746,784	4%
Free Zone FRAY BENTOS - UPM	301,237,280	3%
RUSSIA	276,129,408	3%
HOLLAND	189,744,976	2%
Others	2,729,690,551	30%
TOTAL	9,109,669,543	100%

V.5 Profitability and other indicators of the Financial system in the region

i) Profitability

In most of the selected countries, **profitability** decreases, although it remains high compared to developed countries.

Graph 43 – ROE of banks by country



Source: Central Banks

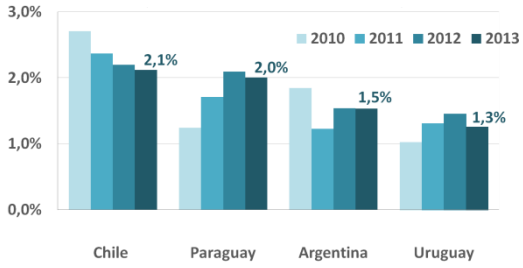
At the country level, Uruguay is the only country that experienced a significant improvement since December 2010. Specifically, the ROE (cumulative annual results in terms of assets) of the Uruguayan financial system, recorded an increase of 9.6 percentage points in the past three years of the analysis period.

In contrast, both Paraguay and Argentina have higher figures. Specifically, while Uruguay reached an 18.6% ratio in December 2013, Paraguay and Argentina showed values of 29.4% and 25.4% respectively.

ii) Arrearage

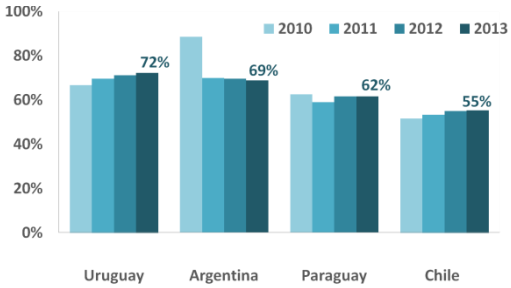
The region has acceptable levels of arrearage. On the one hand, the Uruguayan financial system has on average the less risky portfolio in the region, registering a default rate of 1.3%. Of the other countries considered, Chile reached the highest ratio in December 2013 (2.1%). Note that this country has shown a downward trend in arrears, with a decrease of 0.6 pp in the last three years. In another sense, Paraguay has experienced an increase of 0.8 pp in same period, reaching a ratio of 2.0% in December 2013.

Graph 44 – Arrearage



Source: Central Banks

Graph 45– Cost/Income



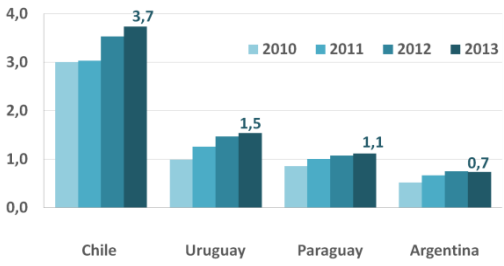
Source: Central Banks

iii) Efficiency indicators

On one hand, a high ratio of costs on operating income for selected countries in the region was observed. In turn, efficiency starts to weaken in most countries (except for Argentina). In recent years, Uruguay has shown higher levels of costs compared to the other countries in this analysis. Specifically, in December 2013, the country recorded the highest cost ratio in terms of revenue, approximately 72%.

Finally, when considering the efficiency measured by the millions of dollars of average credit per bank employee, it was noted that Chile has always been above the others, and that Argentina has the lowest figures.

Graph 46– Credits/Employees



Source: Central Banks

V.6 Type of financing in the region

The main form of financing in the region is through loans. The conditions regarding interest rates, repayment terms and even the form of loan repayment vary from borrowers and lending institutions.

The World Bank is present in the region through the following tools: first, traditional loans for destined to physical and social infrastructure aimed at reducing poverty and creating sustainable development. On the other hand, provides loans for development policies, which consist of quick financial assistance to finance policy and institutional reforms. Thirdly, loans for results, these disbursements are linked to the achievement of certain development results. Finally, the BM provides partial private debt issuances for investment loans in key areas of the country. With these issuances, the country benefits from lower credit cost, and the private borrower eliminates the probability of a loan not being paid.

On one hand the IADB has a wide range of support tools. Most of the projects and programs are financed through loans, either on market conditions or on favorable conditions. Secondly, it grants non-reimbursing loan which are reimbursed only if in the case that the projects receive additional funding. On the other hand, it guarantees loans from private financial institutions to the public and private sectors in ALC. Finally, the IADB's Multilateral Investment Fund (MIF) and the Inter-American Investment Corporation (IIC) invest in the private sector.

Furthermore, CAF loans has short, medium and long term loans, structured funding, A/B loans (in which CAF retains certain rights), financial advice, warranties and guarantees, partial guarantees, equity, treasury services, technical cooperation and credit lines.

With the growing influence of Chinese banks in financing infrastructure in the countries of the region, other less orthodox forms of loan repayment have arisen. One of these is called oil loan. With this tool, large oil producing countries such as Venezuela or Ecuador may benefit from major credit canceling with oil. For example the system of "credit for oil" works as

follows: The BDC Chinese bank makes a loan of USD 1,000 million to the government of Ecuador. The state-owned oil company of the benefited country, Petroecuador in this case promises to send up to a certain amount of barrels of oil per day. Chinese companies that need oil buy this oil at prevailing market price at the time of purchase and deposit the money directly into the account of Petroecuador in the BDC.

Oil loans in Latin America have reached USD 59,000 million in 2008-2012. Since 2008 Venezuela has negotiated six of these loans reaching a total USD 44,000 million, Brazil has participated in this scheme for USD 10,000 million and Ecuador for USD 3,000.

Another aspect to analyze is the interest rate charged by the credit granted. Contrary to what is often manifested, Chinese banks do not offer significantly better terms than Western credit agencies. Although rates vary among different loans and from country to country and often the secrecy in negotiations makes it difficult to find reliable information on the relative loan costs, some authors have found evidence that bank fees from Chinese development banks are high compared to those of the World Bank and the China Ex-Im are lower than the Ex-Im U.S. In effect, during the 2008-2012 period BDC rates have varied around0.5% over LIBOR for Venezuela and 6% over LIBOR for Argentina, while in the same period, rates from the WB varied between 0.05 % over LIBOR for Chile and to 0.85% over LIBOR for Argentina. On the other hand, once the the China Ex-Im risk premium were adjusted they varied significantly lower than the Ex-Im U.S. levels: -0.31 to 0.69% (except in the case of a loan to Ecuador whose adjusted rate was 4.39%) vs. 1.53% to 2.53%. These reduced rates of China Ex-Im responded to an explicit policy of subsidy on Chinese exports, although the OECD countries prohibit combining export credits with development credits.

Amount financed

Another aspect to note is the average amount of the granted loans. While Chinese banks are concentrated in the financing of large investment projects Western banks focus on smaller projects. It is also noted that the only beneficiaries of WB and IADB loans over USD 1,000 million are the 3 largest economies in the region (Brazil, Mexico and Argentina). Such a correlation between economy size and amount loaned is not observed in the case of financing provided by Chinese banks.

To summarize, it is observed that in recent years the region has been a major recipient of loans from both Western development banks and Chinese development banks. However, instead of competing, a certain complementarity in the pattern of financing is observed among these institutions. This complementarity may be observed in the financed areas, the beneficiary countries and the amount of the granted loans.

Table 15 – Loans from WB, IADB y China (USD 1.000 or more)
2005-2011

Million USD	Total	WB	IADB	China
Venezuela	38.500	-	-	38.500
Brazil	17.675	3.445	3.000	11.230
México	11.221	8.021	2.200	1.000
Argentina	11.200	-	1.200	10.000
Ecuador	5.683	-	-	5.683
Bahamas	2.450	-	-	2.450
Total	**86.729**	**11.466**	**6.400**	**68.863**

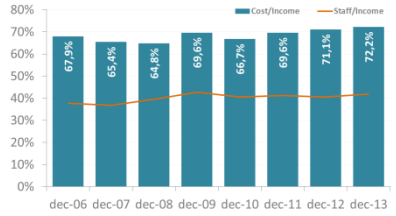
Source: China – Latin América database

V.7 National financial system (cont.)

In terms of efficiency, the Uruguayan financial system also faces a challenge. In particular, the relationship between costs and revenues in recent years, has been significantly high, reaching values higher than 70%. Additionally, it is important to consider that staff costs has historically had a very large share of the total cost (above 55%).

Finally, it is observed that the arrearage system, has dropped significantly in the last decade, reflecting an improvement in the quality of the loans made. Specifically, in December 2003 arrearage percentage was 19.6%, and in December 2013 said percentage dropped to the same 1.4%. Similarly, the provision of non-performing loans has increased 17.4 percentage points over the same period.

Graph 47– Cost/Income Ratio

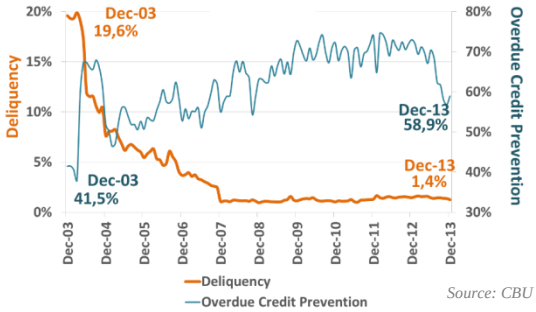


Source: CBU

Turnover

Moreover, in 2013, the Uruguayan banking system recorded a turnover (measured as the sum of total deposits and credits) from the nonfinancial sector of USD 39,574 million, corresponding to 71% of GDP. In particular, the obligations represented 65% of total turnover, said structure has remained relatively stable over the past 10 years.

Graph 48– Deliquency and Overdue Credit Prevention, Private Banks+BROU

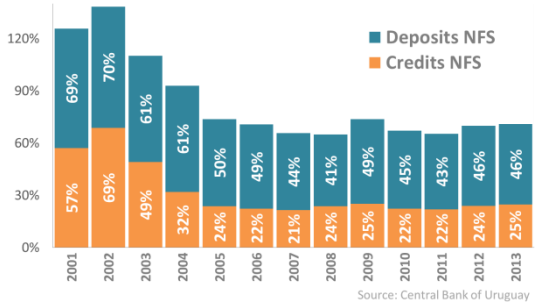


Source: CBU

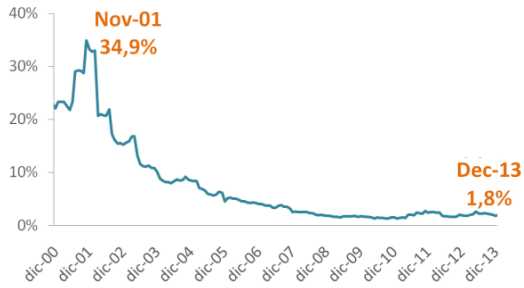
As can be seen in the, in 2002bank turnover with regard to the product was significantly higher, which is due to two main reasons. First, in 2002 the country went through a crisis, which resulted in a historically low GDP level (USD 13,643 million).

The second reason is that the country had a turnover, and in particular a stock of loans with the private non-financial and non-resident that were well above post-crisis levels. In this sense, while in November 2001 they accounted for 34.9% of loans with NFS, in December 2013 it amounted to only 1.8%. Even though bank stocks with residents have evolved in a good way, the system has not recovered to before crisis penetration levels.

Graph 49– Turnover to Non-Financial Sector (%GDP)



Graph 50– Credit to Private NFS No Resident (% Private NFS– Private Bank)



Source: CBU

Another aspect to consider is the dollarization of the Uruguayan financial system. In early 2000, the Uruguayan financial system was characterized by having a high level of loans and deposits in foreign currency (almost entirely U.S. dollars). Specifically, in 2003 79% of

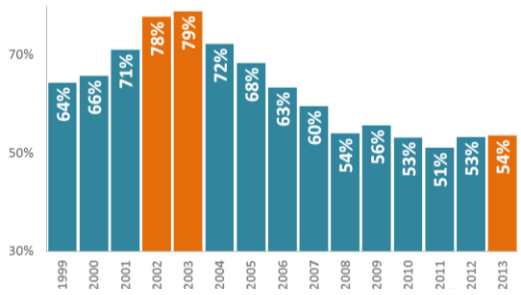
the loans were in foreign currency. However, since 2008, loans in this currency have been kept in 53%.

Moreover, since 2005, bank loans granted for consumption have increased significantly. In September 2013, a 236% increase was recorded. As a result, the share of said loans showed an increase of 11% in the period.

It is important to consider that the increase in credits granted to "households" was also driven by other non-bank financial institutions. This was because in order have access to the "household segment"(consumer banking) banks had to acquire or participate in smaller, specialized companies in the segment to act as their Front Office *(Credit Administrating Companies-CAC, non-bank financial institutions, etc.).*

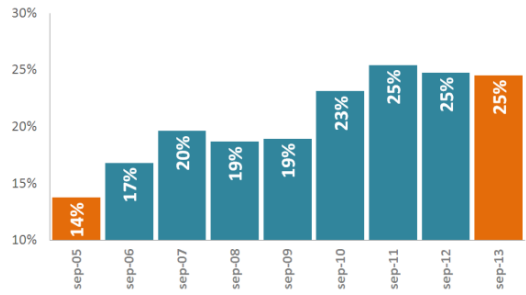
In particular, while in 2005 consumer credits granted by the CACs had represented 18.3% of the total, in 2013 this value increased to 23.9%.

Graph 51– Share in stock of loans to the NFS in local currency (% over total)



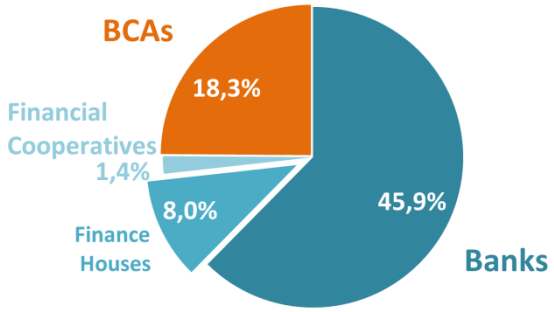
Source: CBU

Graph 52– Share in stock of consumer credit over total loans

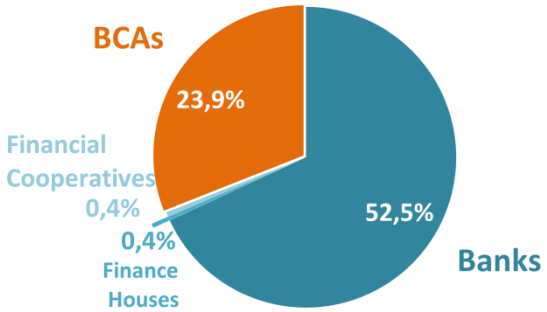


Source: CBU

Graph 44– Consumer Credit Market Share, 2005



Graph 45– Consumer Credit Market Share, 2013



Source: CBU

V.8 Description of the Free Trade Zones scheme

i) Draft amendment of the Free Trade Zones Law

After 25 years under the scheme of the Free Trade Zones Law N°. 15.921 (December 1987), modifications to said law were proposed. Said modifications seek to adjust the scheme so itcan broaden its objectives and put emphasis on specific activities, particularly those related to high technology and innovation, which are starting to be prioritized by the country. However, these modifications will be made over the original law as a sign of stability for the agents that are currently operating in the Free Trade Zones. Some of the proposed changes include name changes from Free Trade Zone to Special Economic Zone (SEZ) and from "operator" to "developer".

Among the reasons outlined by the authorities to submit the changes to the current system, it was suggested that in general the objectives of the law (investment promotion, export expansion, use of local labor, international integration) were achieved but there is still a reminiscent need to achieve a greater decentralization.

At first, when the project was created, the activities that the scheme covered were mainly manufacturing, service and value-added logistics activities.

Manufacturing output was destined mostly to countries in Europe and Asia, while services were directed mainly to the United States.

The estimate of gross value added created in Free Trade Zones corresponded to approximately 4 GDP points in 2010, 50% corresponded to industrial activities, and the rest was divided between logistics and commercial activities, and global services.

It is important to note the number of jobs created (about 15,000 jobs) and the quality of the jobs which employs highly qualified workers.

Thus, the project sought to prioritize the development of industrial activities in new areas and that they be located outside the metropolitan area. Another objective was that these activities imply a determinate economic significance and as well as develop high technology processes.

De esta forma, el proyecto buscaba priorizar el desarrollo de actividades industriales en la creación de nuevas zonas y que las mismas se ubicaran fuera del área metropolitana, e implicaran una significación económica determinada y apuntaran al desarrollo de procesos de alto contenido tecnológico.

It also contemplated the possibility of creating a Service Theme Zone where a specific service could be developed in order to make scheme restrictions more flexible. Such restrictions include retail trade ban in the area, among others.

On the other hand, the National Customs Agency established it could apply entrance, permanence and exit controls on merchandise of the Special Economic Zone, having NCA installations in said facilities in order to comply with these controls.

The draft amendment has passed several times by the Senate Finance Committee after going through several wording changes, and is currently awaiting approval so it can be considered once again by the legislators.

ii) Free Trade Zones located in national territory

There are currently 13 Free Trade Zones in the country, both for public and private exploitation.

Free Trade Zones allow companies to have different companies of different dimensions where they can build their offices according to the requirements. In turn they have space for containers, green areas, and benefit from several different services and facilities.

Illustration 7 – Free trade zones in the country

CPA

Ferrere

Inteligencia aplicada a su negocio

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