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REPORT AND RECOMMENDATION OF THE PRESIDENT

TO THE EXECUTIVE BOARD ON A PROPOSED

TECHNICAL ASSISTANCE GRANT

TO THE

SOUTHERN CONE COMMON MARKET (MERCOSUR)

FOR THE

INSTITUTIONAL AND POLICY SUPPORT PROGRAMME TO ALLEVIATE RURAL POVERTY IN THE MERCOSUR AREA

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POTENTIAL RISKS TO SMALLHOLDERS 1

REPORT AND RECOMMENDATION OF THE PRESIDENT OF IFAD TO THE EXECUTIVE BOARD ON A PROPOSED TECHNICAL ASSISTANCE GRANT TO THE SOUTHERN CONE COMMON MARKET (MERCOSUR) FOR THE INSTITUTIONAL AND POLICY SUPPORT PROGRAMME TO ALLEVIATE RURAL POVERTY IN THE MERCOSUR AREA

I submit the following Report and Recommendation on a proposed technical assistance grant to the Southern Cone Common Market (MERCOSUR) to support the Institutional and Policy Support Programme to Alleviate Rural Poverty in the MERCOSUR Area, in the amount of USD 800 000 for a three-year period.

I. BACKGROUND

1. In November 1997, IFAD's Latin American and the Caribbean Division organized a seminar entitled "Combat Against Rural Poverty Under Market Rules Within the Context of the MERCOSUR", in Montevideo, Uruguay. The seminar was attended by foreign affairs and agriculture ministers, members of the agricultural boards and parliamentarians from the six MERCOSUR countries, and international experts on rural poverty alleviation and rural development. During the seminar, the President of IFAD expressed the Fund's commitment to providing technical, and eventually, financial support to MERCOSUR in its efforts to alleviate rural poverty. Concerned about the risk that trade liberalization might bring to the smallholder rural sector, while taking into account as well the opportunities liberalization presents, government officials agreed as an outcome of the seminar to establish an Institutional and Policy Support Programme to Alleviate Rural Poverty in the MERCOSUR Area.

II. RATIONALE AND RELEVANCE TO IFAD

2. Experts in international trade believe that the overall effect of MERCOSUR will be positive, and that it will reinforce the dynamism of the region. Association with MERCOSUR means assured access to a market of 200 million consumers, and hence major opportunities for market diversification and export expansion. However, benefits associated with MERCOSUR may not reach everyone, especially during transitional periods.[1] There are 90 million people living in poverty within the MERCOSUR countries, 32 million of which live in rural areas. Because small-scale producers often lack the resources necessary to grow export-oriented crops, or because their small enterprises are not linked to the export market, smallholders may not be able to participate in MERCOSUR trade growth. In fact, they may find that commercial expansion has an inflationary effect on production costs and on land rent that may even make their traditional production less feasible. Liberalization does not trickle down to the poorest people in the agricultural sector, at least during the transitional periods**.** The main factors that might exacerbate the potential negative effects of MERCOSUR's trading arrangement are the following: (i) **institutional weakness**, as well as the danger of social exclusion of an important number of marginalized smallholders; (ii) **selective modernization.** While the modern agro-industrial sector is

[1] See Appendix for a summary of Potential Risks to Smallholders.

likely to benefit considerably from MERCOSUR, some sensitive traditional production sectors will need to adjust to trade competition; (iii) **high volatility of the markets**. The last financial crisis in Brazil in January 1999 threatens to disrupt other economies, especially Argentine and Uruguayan exports to that country; (iv) **knowledge and communications capabilities**. These are required to access, analyse and share information required to create knowledge. Without them, small producers remain at the mercy of global market forces; and (v) **risks to food security**. There are concerns that where production for export increases, food consumption and the nutritional status of the poorest households declines. Since many of the rural poor are net-buying smallholders, this transition worsens poverty among them, at least until adjustment creates enough growth, employment and response in the production of non-tradable foods. Small, poor producers are threatened by increased competition from larger farms that have closer and more solid links with the market. It is estimated that more than 2.5 million small landholders and agricultural workers might lose their plots and/or jobs between the years 2000 and 2006 unless appropriate policies are designed to protect them.

3. **Relevance to IFAD.** A partnership with MERCOSUR will: (i) influence, for the first time, subregional, agricultural and rural development policies to combat poverty and mitigate the potential negative effects of MERCOSUR; (ii) help reinforce IFAD's impact on its target population by engaging in policy dialogue with member Governments in order to achieve a favourable macro-economic and institutional environment. This will stimulate the rural poor to mobilize their productive capacities and provide them with greater bargaining position *vis-à-vis* the market, the state and other civil-society organizations; and (iii) disseminate best practices to practitioners, IFAD staff and policy makers by linking with other development agencies, donors and multilateral financial institutions. They will act together and present a common platform for reform with an orientation towards factors on which the welfare of the poor depends, and ensure that the policy environment favours rural poverty reduction. IFAD will support MERCOSUR policies, while fulfilling its mandate of poverty alleviation, by maximizing the use of the opportunities created by the expansion of MERCOSUR markets, and by preventing the potential negative effects on smallholders' economies.

III. MERCOSUR'S PREVIOUS EXPERIENCE

4. MERCOSUR, a trade arrangement among Argentina, Brazil, Paraguay, and Uruguay, represents the fourth most important economic and trading system in the world. The MERCOSUR was established, not as a defence mechanism against economic globalization, but as an active mechanism that advocates an enabling macroeconomic environment for all. Its economic impact is substantial: the new market encompasses 200 million people, a GDP of almost USD 1 billion and more than half of Latin America's market. As of 1 January 1995, with some exceptions (mainly in the agricultural sector), customs duties among Argentina, Brazil, Paraguay and Uruguay were eliminated, and a common tariff for most products implemented. The exceptions to the agreed tariffs are expected to disappear by 2006. Following the successful conclusion of negotiations in the course of 1996, Chile (1 October 1996) and Bolivia (1 January 1997) became Associate Members of MERCOSUR. Negotiations are also under way with other Andean Pact countries to develop a duty-free trade relationship.

IV. THE PROPOSED PROGRAMME

5. The main objectives of the programme will be to: (i) help vulnerable groups be a part of and contribute to the mainstream of the economy by taking advantage of the new niches created by the expansion of MERCOSUR markets; (ii) avoid undesired effects from economic modernization processes and expanded markets; (iii) include a gender-oriented approach that will cut across all programme activities, while enhancing rural women's economic roles and assuring household food security and

nutrition; and (iv) advise and train poor rural farmers/entrepreneurs in complying with the laws, rules and regulations deriving from international agreements and/or commitments such as the MERCOSUR.

6. To achieve these objectives, the technical assistance grant (TAG) proposes to support the programme, while the six MERCOSUR countries will establish a MERCOSUR regional coordinating unit (RCU) within the institutional framework of the MERCOSUR structure headquartered in Montevideo, Uruguay.

7. Established by the six MERCOSUR member countries, the RCU will be responsible for designing appropriate activities under the programme. Its focus will be on the expansion of economic opportunities and productive transformation policies that address the new situation created by the enlargement of the MERCOSUR market. Based on the experiences of IFAD and MERCOSUR, and within the framework of the TAG, the proposed programme will address three broad areas: (i) the design of policies that will increase the competitiveness of peasant agriculture and the appropriate and necessary allocation of resources to implement those policies; (ii) the assessment of the institutional framework of poverty alleviation programmes; and (iii) the participation of farmers' organizations and smallholders in the design of international rural development policies, and the potential for the transformation of smallholders' productive systems.

8. Specific activities under the programme will be: (i) information and outreach; (ii) monitoring, analysis and research; (iii) training and capacity-building; and (iv) design of public policies.

9. **Information and outreach.** The RCU will prepare information materials for distribution to policy makers, opinion leaders and rural leaders, and the rural community at large. It will provide technological, economic, commercial and methodological information to the national/local, public/private offices responsible for the design of rural poverty alleviation policies. In addition, it will be a two-way channel, with information emanating from the RCU, and provided by farmers' organizations and the rural communities. Outreach activities will include a literature service, databases, video productions, conferences and computer networks. The RCU will document best practice.

10. **Monitoring, analysis and research.** The RCU will monitor key events and topics related to agriculture, the environment, community economic development and trade. The data will then be analysed to determine potential social and economic implications. Policy options will be researched and presented in response to specific problems and opportunities. The main recipients of this information will be the ministries of agriculture and other relevant agencies. The RCU could also advise private and non-governmental organizations upon specific requests.

11. **Training and capacity-building.** The RCU will design training modules based on the RCU's own experience and knowledge of the different programmes and organizations involved in rural development. The RCU will not be directly involved in training, but it will provide methodological support and disseminate best practice.

12. **Design of public policies.** The RCU will offer expertise and best practice in the design of poverty alleviation policies to member governments, their relevant agencies and international development organizations. The policies and strategies will be in accordance with macroeconomic policies and the norms and objectives of the MERCOSUR. The RCU will organize highly interactive participatory meetings, seminars and conferences with different Government officials and representatives from international development organizations.

V. IMPLEMENTATION ARRANGEMENTS

13. The programme will be implemented by the RCU, which will have a steering committee formed by delegates of the six participating countries. A technical committee formed by a small group of professionals, led by a coordinator based in Montevideo on the premises of the Administrative Secretariat of MERCOSUR, will execute the programme.

14. Based on a proposal of the technical committee, the steering committee will offer an annual working plan that details areas of intervention in which the programmes of assistance and research will be delivered. IFAD will participate during the final meeting when the annual plan will be approved.

15. The technical committee will provide annual progress reports to IFAD and be in charge of supervising national activities. It will contract an independent firm to carry out an annual auditing. The report will be sent to IFAD no later than three months after fiscal year ends.

16. The grant agreement will contain all the details that regard reporting, auditing, participation of IFAD in the annual working plan, and supervision arrangements.

VI. EXPECTED OUTPUTS/EXPECTED BENEFITS

17. By the end of the TAG, the main outputs will be: (i) dissemination and exchange of information between public and private organizations; (ii) feasibility studies indicating the potential and comparative advantages for market penetration of poor smallholders' products and the potential for the transformation of peasant's productive systems; (iii) rural leaders, government officials and field programme officers trained in the different educational processes needed by the rural communities to be able to participate in a highly competitive trading environment; and (iv) public policies that address the competitive fields of increased market integration and globalization with the need to alleviate rural poverty.

VII. INDICATIVE PROGRAMME COSTS AND FINANCING

18. The total cost of the programme will be USD 1 300 000 over a period of three years. Participating MERCOSUR countries will contribute USD 392 000; the MERCOSUR Administrative Secretariat will cover USD 108 000 in kind (facilities and general services); and IFAD will provide a TAG for USD 800 000. The TAG will only finance activities related to capacity-building and policy aspects of the programme, while costs associated with human resources, facilities, equipment and supplies will be provided by the member governments (see the table below).

PROGRAMME COSTS AND FINANCING AND ESTIMATED ALLOCATION OF IFAD GRANT (USD)

Activities	IFAD	MERCOSUR Countries	MERCOSUR Administrative Secretariat	Total	%
I. CAPACITY-BUILDING					
1. Information and outreach					
Literature service	43 000			43 000	3.3
Databases	82 000			82 000	6.3
Video production	70 000			70 000	5.4
Conferences	55 000			55 000	4.2
2. Monitoring, analysis and research					
Studies	40 000			40 000	3.1
Computer networks	90 000			90 000	6.9
3. Training and capacity-building					
Training modules	75 000			75 000	5.8
Seminars	60 000			60 000	4.6
Staff/leadership training	60 000			60 000	4.6
Teleconferences	75 000			75 000	5.8
4. Design of public policies					
Seminars	35 000			35 000	2.7
Conferences	40 000			40 000	3.1
Study tours	50 000			50 000	3.8
5. Start-up seminars in six countries		180 000		180 000	13.9
Subtotal	**775 000**	**180 000**		**955 000**	**73.5**
II. INSTITUTIONAL STRENGTHENING					
1. Human resources		212 000		212 000	16.3
2. Equipment/facilities/supplies			108 000	108 000	8.3
Subtotal				**320 000**	**24.6**
Contingencies	25 000			25 000	1.9
Total cost	**800 000**	**392 000**	**108 000**	**1 300 000**	**100**

VIII. RECOMMENDATION

19. I recommend that the Executive Board approve the proposed technical assistance grant in terms of the following resolution:

> RESOLVED: that the Fund, in order to finance, in part, the Institutional and Policy Support Programme to Alleviate Rural Poverty in the MERCOSUR Area, for three years, commencing in April 2000, shall make a grant not exceeding eight hundred thousand United States dollars (USD 800 000) to the Southern Cone Common Market (MERCOSUR) upon such terms and conditions as shall be substantially in accordance with the terms and conditions presented to the Executive Board in this Report and Recommendation of the President.

Fawzi H. Al-Sultan
President

POTENTIAL RISKS TO SMALLHOLDERS

1. The following are potential risks to smallholders from the implementation of MERCOSUR trading policies:

2. **Institutional weakness** and the danger of **social exclusion** of a large number of marginalized people. The task of transforming the cluster of state institutions in the rural sector has been very significant. However, in spite of some important progress, much remains to be done, and there is a lack of institutional answers to the demand and needs of less endowed producers. This contributes to social unrest, migration, overpopulation and unemployment in urban areas, contributing in turn to political instability and social tension, and perhaps working against the process of regional integration. A continuing rural institutional crisis can create or deepen the stagnation of the agricultural sector as long as there are no new institutional structures able to open new channels through an effective economic development supported in the long term by a rural development vision. Such a vision would allow for greater balance in the relations between the agricultural sector and the rest of the national and regional economies.

3. **Selective modernization.** This is the basis for the deepening productive and social imbalances in the rural sector, under conditions in which the macroeconomic environment of a country by itself cannot offer a real and lasting alternative for the displaced actors or regions in the countryside. Thus a new shape is given to the restructured countryside: **vacuum plus exclusion**. According to FAO's *State of Food and Agriculture 1997*, while the modern agro-industrial sector is likely to benefit considerably from MERCOSUR, some sensitive traditional production sectors will need to adjust to trade competition. Such adjustment is to be facilitated by the periods that were allowed for duty reduction, as well as by the new programmes of investment in rural infrastructure. However, the main question is whether the time is used to provide small farmers and producers with the necessary skills and productive assets (such as credit, land and water, management, technological know-how, etc.) that will allow them to learn to compete with larger and more advanced farmers and agribusinesses.

4. **High volatility of the markets.** The last financial crisis in Brazil in January 1999 threatens to disrupt other economies, especially Argentine and Uruguayan exports to that country. Yet, even before the financial crisis, and with unchanged nominal exchange rates, a more expansionary monetary policy led to increases in the price of non-tradables and a decline in the real exchange rate (defined as the price of tradables over non-tradables), with the usual impact of reduced exports and larger imports. This result suggests that the current bilateral trade balance between Argentina and Brazil is influenced as much by diverging macroeconomic conditions as by the implementation of the trade liberalization aspects of MERCOSUR. It points to the importance of mechanisms to ensure that macroeconomic conditions in trading partners work in concert with the trade liberalization process.

5. **Diversification**. Assessments have shown that gains from liberalization may not come from the region's traditional export commodities. The export market in agricultural commodities has changed considerably in recent years. In fact, the main source of growth in agricultural exports comes increasingly from non-traditional commodities, processed products and expansion into new markets. Thus, the opportunities for MERCOSUR countries will more and more come from exploiting diversification possibilities, at the geographical level, by expanding into fast-growing import markets; at the horizontal level, by increasing the spread of commodities exported; and vertically, by increasing the value-added for exported products. One of the best opportunities for poor smallholders is to reconvert their economies using the niches that the expansion of the MERCOSUR markets will create. Implementation of this proposal will facilitate the first feasibility studies to determine smallholders' competitiveness. IFAD already has positive experience in diversifying crops. The IFAD project assisted small producers of sugar

beats (*remolacha azucarera*) to begin producing out of season fruits (*fruta primicia*) using rustic nurseries and adapted, low-cost technology. The small farmers have become successful exporters of fruits to the MERCOSUR market, overcoming poverty and social marginalization. Previous to beginning product diversification, the German Agency for Technical Cooperation carried out some feasibility studies.

6. **Food security**. There are concerns that where production for export increases, food consumption and the nutritional status of the poorest households declines. For example, if increased production for export reduces local food availability, local food prices will rise. The nutrition of the rural poor who do not share in the benefits from export crops, but purchase food in the same markets may suffer. In addition, if export production is less labour-intensive than staple food production, the undesirable effect is unemployment. Similarly, when the export crop income is controlled by male heads of households, who are usually less likely to spend this income on food, then the food security of women and children in the household may be put at risk. Rural poverty and food security issues will not be resolved by just reforming the world agricultural trading system, or by policy reforms in farming among the main trading partners. While creating incentives for sellers of an agricultural surplus, the process of adjustment typically raises the price of food and increases unemployment.

7. **Knowledge and connectivity.** The idea that communities of small-scale agricultural producers are isolated and live in closed, self-sufficient societies is a myth. Global trade relationships, such as MERCOSUR, place rural communities and small-scale agricultural producers squarely in the middle of global market realities. Without knowledge and without the communications capabilities required to access, analyse and share the information required to create knowledge, small producers remain at the mercy of global market forces. The new information and communications technologies, such as the Internet, and new approaches to access and use technologies by people living in poverty, can help fulfil social development goals. Therefore, the need to facilitate access to such technologies is recognized.

8. **Liberalization does not trickle down to the poorest people in the agricultural sector**, at least during the transition period. Since many of the rural poor are landless and net-buying smallholders, this transition worsens poverty among them, at least until adjustment creates enough growth, employment and response in the production of the non-tradable foods. There are 90 million people living in poverty within the MERCOSUR countries, 32 million of which live in rural areas. According to a World Bank study (1995), of the two largest economies of the MERCOSUR, i.e., Brazil and Argentina, approximately 51% (18 million) of poor people in Brazil lived in rural areas. Twenty-four per cent and 59% of the illiterate population live in urban and rural areas, respectively. Most rural heads of households are self-employed or small producers (48% of the total), followed by wageworkers, and seasonal or permanent workers. Based on a Basic Needs Assessment classification, in Argentina one fourth of the population live in rural areas; fifty-seven per cent of them live in the north-west and north-east of the country; two thirds of the rural population depend on agriculture, of which 35% are small farmers or non-waged family workers and 30% wage workers. Thirty-nine per cent of agricultural landholdings, or the equivalent of 1.5 million people, are considered poor according to Basic Needs Indicators, and they rely mostly on family labour. A third of this figure do not have proper title to the land, and 78% do not receive any technical assistance. The situation in Chile and Uruguay is similar to the one in Argentina and Brazil, and it worsens in the case of Bolivia and Paraguay.