10 YEARS OF ECONOMIC RESEARCH IN THE MERCOSUR NETWORK

2008
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THE MERCOSUR NETWORK

The Mercosur Economic Research Network (Mercosur Network) has been working since 1998 in the production of joint studies and researches on relevant issues to the integration process.

The Mercosur Network's original and characteristical aspect is that the researches are done by teams of experts belonging to the four Mercosur member countries, aiming to create a regional vision of the problems faced by the integration process.

We intend to introduce of a distinct "Mercosur perspective" in the present regional economic debate, and this is one of the main challenges drew by the Mercosur Network.

With this purpose, we have undertaken ambitious research activities on the following subjects:

- Macroeconomic Policies Coordination
- Not-tariff barriers to regional trade
- Foreign Direct Investment in Mercosur
- Common Trade Policy
- External negotiations: Mercosur-FTAA / Mercosur-EU / Mercosur-WTO
- Productive Complementation in Mercosur
- Asymmetries in Mercosur

Common External Tariff Reform, Mercosur-South Africa and Mercosur-Canada Negotiations are other issues that have been tackled by the Mercosur Network.

Research work is published in our series of edited books, working papers and Brief series, as well as in our web site www.redmercosur.org.

We encourage the articulation of knowledge with the needs and demands of policy makers, negotiators, civil society and other key actors participating in the integration process. Consequently, we have organized numerous Workshops and Regional Forum to discuss and broadly disseminate the results of our work.

The Network has cooperated with Mercosur's successive pro-tempore presidencies, with the Mercosur Secretariat (SM), the Mercosur Committee of Permanent Representatives (CRPM), the Mercosur Parliament and the Economic and Social Consultative Forum (FCES).
OBJETIVES

The main goal of the Mercosur Network is to maximize the contribution of economic research to the advancement and deepening of the Mercosur integration process. This goal is developed through the following specific objectives: to promote, coordinate and develop joint studies on issues relevant to the integration process, from an independent and rigorous perspective; to identify priority issues for research within the region and carry out comparative work based on common methodologies that help create a regional vision of the problems faced by the integration process; to highlight the role played by independent economic research in public debate on the integration process, to balance the political and sectoral visions that tend to dominate the current debate; to create a space of open policy debate on common policies for Mercosur and on how the bloc responds to the changes in the international context, and/or other common challenges to member countries; to articulate the generation of knowledge with the needs and demands of policy makers, negotiators and other actors participating in the integration process and to discuss and broadly disseminate the results of studies developed within and outside the Network, with the objective of reaching all key sectors in the integration process and to foster the relationship among technical teams working at the regional level.
MEMBERS

The Mercosur Economic Research Network (Mercosur Network) links twelve institutions with broad experience in the field of economic research and a solid track record in the study of the Mercosur integration process.

The following institutions are part of the Network:

ARGENTINA
Centro de Estudios de Estado y Sociedad (CEDES)
Centro de Investigaciones para la Transformación (CENIT)
Instituto Torcuato Di Tella (ITDT)
Universidad de San Andrés (UdeSA)

BRAZIL
Instituto de Economia, Universidade Estadual de Campinas (IE/UNICAMP)
Instituto de Economia, Universidade Federal de Rio de Janeiro (IE/UFRJ)
Instituto de Pesquisa Economica Aplicada (IPEA)
Fundação Centro de Estudos do Comércio Exterior (FUNCEX)

PARAGUAY
Centro de Análisis y Difusión de Economía Paraguaya (CADEP)
Universidad Católica Nuestra Señora de la Asunción (UCNSA)

URUGUAY
Centro de Investigaciones Económicas (CINVE)
Departamento de Economía, Facultad de Ciencias Sociales, Universidad de la República (DE/FCS)

The Mercosur Network is opened to the incorporation of new members in the future.
FINANCING

Since its creation, the Mercosur Network has received funds from the international cooperation contributed by the International Development Research Centre (IDRC-Canada). Additional funding has been provided by the Organization of the American States (OAS), the Inter American Development Bank (IDB), the Pérez Guerrero Trust Fund / G77, the Tinker Foundation (NY), the Woodrow Wilson Center (WWC), the Konrad Adenauer Stiftung (KAS), and the Swiss Agency for Development and Cooperation.
**PUBLICATIONS**

**MERCOSUR Network Series**

**Number 1:**
*Foreign Direct Investment in Mercosur*
Coordinated by: Daniel Chudnovsky (CENIT)

**Number 2:**
*Coordination of Macroeconomic Policies in Mercosur*
Coordinated by: José María Fanelli (CEDES)

**Number 3:**
*On the benefits of full integration in Mercosur*
Coordinated by: Julio Berlinski (ITDT)

**Number 4:**
*Integration for growth: Assessment and Perspectives of the Mercosur in its first decade*
Coordinated by: Daniel Chudnovsky (CENIT) and José Ma. Fanelli (CEDES).

**Number 5:**
*Towards a Mercosur Common Trade Policy*
Coordinator: Marcel Vaillant (DECON-FCS)

**Number 6:**
*Basis for the Macroeconomic Coordination in Mercosur*
Coordinator: Fernando Lorenzo (CINVE)

**Number 7:**
*The Industrial Development in Mercosur: The impact of the foreign firms*
Coordinator: Mariano Laplane (UNICAMP)

**Number 8:**
*15 years of Mercosur: Trade, Macroeconomics and Foreign Investments*
Coordinators: Julio Berlinski (ITDT), Francisco Pires de Souza (IE/UFRJ), Daniel Chudnovsky and Andrés López (CENIT)

**Number 9:**
*Economic Growth, Institutions and Trade Policy in Mercosur*
Coordinator: Honório Kume (IPEA)

**Number 10:**
*Productive Complementation for Growth in Mercosur*
Coordinator: Andrés López (CENIT)

**Number 11:**
*Economic Growth, Institutions and Financing Integration Policies in Mercosur*
Coordinator: José María Fanelli (CEDES)

**Number 12:**
*Asymmetries in Mercosur: Impediment for Growth?*
Coordinators: Fernando Masi (CADEP) and María Inés Terra (DECON)

**BRIEFS**

**MERCOSUR Series**

**Number 1:**
*Trade, Foreign Exchange Regime and Volatility: Coordination of Macroeconomic Policies in MERCOSUR*
Coordinator: José María Fanelli (CEDES)

**Number 2:**
*The MERCOSUR Foreign Direct Investment boom in the 1990's: characteristics, determinants and impacts*
Coordinator: Daniel Chudnovsky (CENIT)

**Number 3:**
*On the benefits of full integration in MERCOSUR. An economic evaluation of restrictions to internal trade and its regional impact*
Coordinator: Julio Berlinski (ITDT)

**Number 4:**
*Towards a Common Trade Policy in MERCOSUR*
Coordinators: Marcel Vaillant (DECON-FCS), Julio Berlinski (ITDT), Honório Kume (IPEA)

**Number 5:**
*Basis for a Macroeconomic Cooperation in MERCOSUR*
Coordinator: Fernando Lorenzo (CINVE)

**Number 6:**
*The industrial development in MERCOSUR*
Coordinator by: IE-UNICAMP, CENIT, DECON
Mercosur - FTAA Series:

Number 1:
Negotiations of the MERCOSUR with the FTAA and the US
Fernando Lorenzo and Rosa Osimani

Number 2:
MERCOSUR - FTAA Trade: overview and some indicators of relevance
Rosa Osimani

Number 3:
Integration of the Americas: Welfare effects and options for the MERCOSUR
Silvia Laens and Maria Inés Terra

Number 4:
The sectorial impact of an Integration Agreement between MERCOSUR and NAFTA: The case of the Petrochemical Industry
Andrés López and Gastón Rossi

Number 5:
The sectorial impact of an Integration Agreement between MERCOSUR and NAFTA: The case of Frozen Concentrated Orange Juice (FCOJ)
Paulo Sérgio Fracalanza, Adriana Nunes Ferreira and Marcos Fava Neves

Number 6:
WTO commitments and Policy issues of MERCOSUR and NAFTA countries
Julio Berlinski

Number 7:
Winners and losers in a Free Trade Area between the United States and MERCOSUR
Marcel Vaillant and Alvaro Ons

Number 8:
Negotiating the FTAA between the main players: The US and MERCOSUR
Fernando Masi and Carol Wise

Number 9:
FTAA: Assessments and perceptions of the Brazilian government and production sectors
João Bosco Mesquita Machado and Galeno Ferraz

Working Documents

Productive Complementation in the Software Industry in MERCOSUR countries: fostering regional complementation to participate in the global market.
Coordinator: Andrés López (2007)

Productive Complementation in MERCOSUR, perspective and possibilities
Andrés López (CENIT, Argentina) y Mariano Laplane (UNICAMP, Brazil); Ed. FESUR (2004)

Contributions to the elaboration of proposals of policy in the infrastructure area
Mario Ibarburu, Andrés Pereyra y Dario Sarachaga (DECON, Uruguay); Ed. FESUR (2004)

The Mercosur and the creation of the Free Trade Area of the Americas (FTAA)
Marcel Vaillant (DE-FCS - Uruguay) and Fernando Lorenzo (CINVE-Uruguay); Ed. Konrad Adenauer Uruguay (2003)

Agreement of Interests, Effectiveness of the Rules of Game and Institutional Quality in the Mercosur
Félix Peña (Consultative Council Mercosur Network - Argentina); Ed. Konrad Adenauer Uruguay (2003)

The external agenda of the MERCOSUR: the impact of negotiations with FTAA, EU and WTO
Silvia Laens e Inés Terra (2006)

Preferential Trade Agreements: are Rules of Origin a Protective Device?

Regional integration and foreign direct investment: the potential impact of the ftaa and the EU-Mercosur agreement on fdi flows into Mercosur countries
Andrés López y Eugenia Orlicki (2006)

Regional integration and foreign direct investment: the potential impact of the FTAA and the EU-MERCOSUR agreement on FDI flows into MERCOSUR countries: winners and losers
Gustavo Bittencourt, Rosario Domingo y Nicolás Reig Lorenzi (2006)

Regional integration and foreign direct investment: the potential impact of the FTAA and the EU-MERCOSUR agreement on FDI flows into MERCOSUR countries: sectoral analysis
Celio Hiratuka y Rodrigo Sabbatini (2006)
## SEMINARS AND REGIONAL FORUMS*

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<td>Workshop: The external agenda of Mercosur: The impact of three simultaneous negotiations (FTAA, EU, WTO)</td>
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<td><strong>March, 14th</strong></td>
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<td>Mercosur: A Status Report and Prospects for Canada-Mercosur Relations. Organized by: FOCAL</td>
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* The contents of these Seminars and Events are available in: www.redmercosur.org
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10 YEARS OF ECONOMIC RESEARCH IN THE MERCOSUR NETWORK
The MERCOSUR Network was created in 1998 with the participation of nine academic institutions from the four MERCOSUR countries and has been financially supported by the IDRC since its founding. From this date the Network has developed researches in topics relevant to the process of integration from an independent and rigorous academic perspective.

Teams of experts from the four MERCOSUR countries carry out the Network's research in the hope of achieving a regional vision (and not just a national one) that addresses the problems posed by integration, introducing a "MERCOSUR perspective" in the regional economic debate. The Network's research activities have had different phases since 1998 whose results have received positive evaluations from outside observers and have been welcomed by political actors who are involved in the regional decision making process.
10 years of economic research in the MERCOSUR Network

The economic fields in which the Network developed research projects in its first phase were:

1. Coordination of macroeconomic policies
   In its beginning the Network studied the effect of production in the member countries of MERCOSUR and its trade patterns on macroeconomic dynamics; and the effects of the patterns of change and macroeconomic policies on the productive and trade performance of the region. Subsequently, the Network analyzed the changes brought about by the crisis 1999-2002, in terms of both restrictions of and new opportunities for macroeconomic coordination in the region. The work led to a comparative analysis of other regional agreements and reached numerous conclusions regarding the identification of monetary and exchange rate patterns "more suitable" for the region in the long run; and for constructing institutions for macroeconomic cooperation.

2. Trade Policy
   In the first place, the Network analyzed trade policy towards a deep integration identifying possible instruments, their costs and made policy recommendations. In its second phase, it focused on the study of the existing relation between trade liberalization and economic growth in the MERCOSUR countries. More specifically, it analyzed the impacts of the trade policy starting in 1990 on the total productivity of the factors, private investment, employment and domestic production. This phase concluded with an analysis of the trade policy of each member country in conjunction with that of the region, and a comparative study with the rest of the world.

3. Foreign Direct Investment in MERCOSUR
   In this area the first completed studies focused on accumulating and gathering up-to-date information, analyzing the trade behavior of transnational companies (TNCs), investigating new aspects relevant to growth and trade, and outlining policy designs so that policymakers can take advantage of FDI and its contribution towards development. Initially, the studies focused on the principal patterns of the FDI boom in the 90s and the impact of the TNCs on trade, taking into account policies to attract FDI and promote competitiveness in MERCOSUR. Subsequently, it further gathered information by analyzing the determinants of FDI in the MERCOSUR countries and of intra-MERCOSUR FDI.
The research results were published in the following books available on the Network's webpage (http://www.redmercosur.org): 1. The boom of FDI in MERCOSUR; 2. Coordination of macroeconomic policy in MERCOSUR; 3. The benefit of full integration in MERCOSUR; 4. The challenge of integrating for growth. Outcome and perspectives of MERCOSUR in its first years; 5. Towards a common trade policy in MERCOSUR; 6. Basis for macroeconomic cooperation in MERCOSUR; 7. Industrial development in MERCOSUR. What has been the impact of foreign companies?

The second phase involved a revision and update of the research already completed whose results were published in: 8. 15 years of MERCOSUR: trade, macroeconomics and foreign investments.

Also, in this phase three new institutions were incorporated into the Network and four lines of research which gave continuity to the previous work were developed. They include new areas of interest in the process of integration, with an emphasis on the problems of economic growth of the region. The principal results of these researches are summarized in the articles that accompany this document and refer to:

1. Economic growth, institutions and policies of financial integration
   This work studies the conditions for financial integration in MERCOSUR. It characterizes the institutional and capacity requirements in light of the level of financial development in the countries involved. It analyzes how financial integration, as a key component in the creation of a unique market, can stimulate further integration leading to additional economic growth in the region.

2. Productive complementation to achieve growth
   This is an updated analysis of the situation and the tendencies of the automobile industry in the MERCOSUR countries as well as the strategies of the principal automobile and autoparts producers in the region. It formulates policy recommendations to overcome the asymmetries in trade within the region, to facilitate the process of the sector restructuring, to obtain competitive profits and to promote a better export insertion at a global level.

3. Economic growth, institutions and trade policy
   Presenting the relation between trade liberalization and economic growth in the MERCOSUR countries, this research shows the impacts of the trade policy beginning in 1990: (i) the total productivity of the factors; (ii) private investment through a price reduction of capital goods; and (iii) employment and domestic production.

4. Asymmetries and growth
   This is an examination of the diverse levels of growth and development between countries and regions of MERCOSUR and the inequalities that arise as a result. It tries to understand the nature of these asymmetries and the impediments they
produce to full participation as beneficiaries of the process of integration. It makes common policy recommendations that contain effective measures to reduce the structural asymmetries and those derive from a very discretional use of national public policy.

The results were published in the following books: 9. MERCOSUR: integration and strengthening of financial markets; 10. The automotive industry in MERCOSUR; 11. Economic growth, institutions, trade policy and defending competition in MERCOSUR; and 12. Asymmetries in MERCOSUR: an impediment to growth.

Currently the Network is finalizing four additional research works that were selected by means of a competitive process and refer to the following themes:

Potential profits in regional trade of services in MERCOSUR: This work evaluates the liberalization of telecommunication and financial services done by the MERCOSUR countries in the context of the GATS and of the Protocol of Montevideo. It analyzes the economic policies that were used, the market structure and the sectoral behavior. It also evaluates the potential profits from the liberalization of the trade of services using a model of general computed equilibrium.

Indicators and policies of competitiveness in MERCOSUR: This work generates a set of analysis and information on the policies and indicators of industrial competitiveness in MERCOSUR to improve the design and implementation of public policy with an impact on the manufacturing sector, at both the national and regional level.

Fiscal space for growth in MERCOSUR: Analyzing the implications of the current macroeconomic setting in MERCOSUR, this work identifies opportunities for growth that could arise from implementing new strategies for economic policy coordination.

Diagnosis of growth in MERCOSUR: regional and competitiveness dimensions: This topic outlines a consistent micro-macro model from the factors that carry restrictions to the growth of productivity, selfdiscovery and competitiveness. It identifies the principal restrictions and the opportunities that would mitigate these restrictions on growth and competitiveness by means of adopting regional initiatives.
I. RESEARCHES ON MACROECONOMICS IN THE MERCOSUR NETWORK

It has been seventeen years since the Asunción Treaty gave rise to the Southern Common Market (MERCOSUR). During this period, global and regional integration contexts were subject to important changes and, with them the challenges to advance, and, sometimes, simply not to reverse the integration process. The challenges imposed by the macroeconomic situation were, undoubtedly, among the most arduous that the authorities had had to face. To contribute to a better understanding of those challenges and offer some policy recommendations, the macro research team of the MERCOSUR Network (the “Net”, thereafter) has tried to determine the obstacles and opportunities for integration at the macroeconomic level, in line with the primary goal of the Net, namely, to produce and disseminate applied research on the economic problems in the region.¹

After a decade of research, the Net has managed to accumulate valuable “social capital”, by constituting itself as a means for interaction between policy makers and research centers in the region. Also, the Net has accumulated knowledge capital that has allowed it to contribute to the intellectual sphere and to offer recommendations on macroeconomic policy. The dissemination activities have been varied, from book publications to the generation of linkages with the social actors involved (for more data, see www.redmercosur.org).

The purpose of this document is to show briefly the most important results of our research. First, we provide a broad view of the problems facing the region and our contribution to its better understanding. Then, we comment on our findings in greater detail.

¹ The macroeconomic group was integrated by: Centro de Estudios de Estado y Sociedad (CEDES) from Argentina, Universidad Torcuato Di Tella (UTDT) from Argentina, Centro de Investigaciones Económicas (CINVE), from Uruguay, Universidades Federal do Rio de Janeiro (UFRJ) from Brazil and Centro de Análisis y Difusión de la Economía Paraguaya (CADEP), from Paraguay.
The focus of our research has been changing over time as changes in the integration process itself have begun to arise. For that reason, it would be difficult to make a brief presentation of our results without taking into account such changes. From the point of view of the macroeconomic challenges, three stages in the evolution of the MERCOSUR can be distinguished (Box 1 displays further details on the evolution of trade and growth in the region).

• The initial stage of the integration process. This stage was characterized by high economic growth and macroeconomic vulnerability (fiscal and external deficit and unsustainable debt paths). During this stage, the relevant questions from the macroeconomic perspective were:
  
  i. What will the effects of the changes in the trade structure be (that is, the intensification of its regional dimension) on the macroeconomic interdependence of the member states? Will it modify the nature of the (national) business cycle? Will it be necessary to coordinate national policies?
  
  ii. How can we improve the evolution of the macroeconomic fundamentals so as to reduce external and fiscal vulnerability? What is the best role MERCOSUR can play?
  
  iii. Considering other experiences of regional integration, would the integration process seek to become a monetary union?

• The crisis stage and regime change. Following the macroeconomic crisis and the empirical corroboration of the high macroeconomic vulnerability in the region, the policy questions changed:
  
  i. What effects will the macroeconomic crisis have on regional trade and the overall integration process? How can we distinguish between the short- and long-run effects of crisis?
  
  ii. What are the main characteristics of the new macroeconomic regimes implemented and what consequences do they have on key issues, such as the behavior of the bilateral real exchange rates and trade flows?
  
  iii. How has the space for macroeconomic policy coordination changed? What options are still open?

• The growth recovery stage. This stage has two distinctive characteristics. First, macroeconomic vulnerability has diminished due to the appearance of the "twin surpluses" (the fiscal primary surplus and the current account surplus). Second, member states have renewed the path of economic growth while some partners are experiencing very high growth rates. The questions are:
i. How can we take advantage of the reduction in macroeconomic vulnerability to consolidate the region as a zone free of crisis and, perhaps, to move forward in the coordination of macroeconomic goals?

ii. Can MERCOSUR act as an instrument for national financial development as a result of deepening the integration process? Can regional financial institutions improve the management of external shocks and reduce the cost of accumulating international reserves?

iii. Is there space for a new regionalism that focuses on policies for competitiveness and growth for the regional space as a whole?

**Box 1 / Economic growth and integration in the MERCOSUR**

In the text we mentioned three stages in the history of the MERCOSUR. These stages were marked by abrupt changes in the growth path of each country. In order to explore this issue, the following panel plots the evolution of the Gross Domestic Product (GDP) at constant prices for Argentina, Brazil, Paraguay, and Uruguay in the period 1991-2006. Note that it is easy to distinguish the three stages. The first one covers the period 1991-1997/98 and is characterized by a favorable evolution of the GDP in all the countries. The second stage (1998-2003/04) shows a break in the growth path in which Brazil's growth decelerates and Argentina, Paraguay, and Uruguay undergo a strong contraction. Finally, in recent years the recovery phase appears to have been left behind and the path of economic growth of the first stage retaken. Thus, we can expect the ability and the will for macroeconomic policy coordination to have diminished during the crisis or deceleration stage and that the debate seems to have been renewed.

**Panel I.**

GDP performance in Argentina, Brazil, Uruguay, and Paraguay since the creation of the MERCOSUR

*Source: Centro de Economía Internacional, Argentina.*
What happened to integration during each of these stages? Figure 1 shows regional exports and imports as a proportion of total exports and total imports. Note that: trade during the first stage grew significantly between the countries of the MERCOSUR in relation to trade with the rest of the world. In particular, the export profile was modified substantially. The proportion of exports to the region in relation to total exports was duplicated in the period 1991-1998. With the regional crisis of the end-of-decade (second stage), the relative participation of the “outside MERCOSUR” destinies took on greater importance because they could take distance from the slowdown of GDP that was operating in the MERCOSUR. In fact, in terms of integration on the side of exports, we returned to the situation prior to the treaty. Finally, during the third stage this stylized fact remains, in spite of the return of economic growth.

Figure 1. Evolution of regional trade since the creation of the MERCOSUR

In the process of analyzing these questions that arose naturally from the macroeconomic performance of the region, a learning process developed that was very useful to social and political actors, as well as to those who studied the region’s problems. In this sense, the research of the Net suggests that the following points stand out.

- Regional integration through MERCOSUR generates gains in the diversification of trade and in productive complementation by intensifying intra-industry trade that can be helpful in promoting growth and macroeconomic stability. During this stage, in which all the economies grew simultaneously, the regional trade was instrumental not only for the increased volume of trade but also for the sophistication and diversification of products.
• To facilitate the integration process it is necessary to lower the volatility of bilateral real exchange rates. In periods of low real exchange rate volatility, stability facilitated trade relations and the regional long-run investment - especially oriented to productive complementation - whereas in periods of high real exchange rate volatility, the rules of the game changed constantly destroying the incentives to trade and investment in productive complementation.

• National business cycles have an important idiosyncratic component. Shocks that generate aggregate fluctuations are largely rooted in the specific problems of each country. So, there is room for macroeconomic policy cooperation in smoothing the business cycles. Nevertheless, our studies show that besides the shocks that give rise to fluctuations, the effects of the “second round” on the rest of the partners cannot be overlooked and the crises are particularly harmful.

• Macroeconomic crises and regime changes have diverse impacts on the integration process. When a crisis produces a growth collapse in a country, the fall in domestic absorption has negative effects on other members’ exports. Also, crises imply protectionist ruptures of rules, contracts, and pressures, which generate a bad climate for the institutional development of MERCOSUR.

• The volatility of financial flows shocks represents a common shock to the region. The cases of high volatility are associated with financial crises. Therefore, there are gains in working on the creation of a regional financial architecture that would generate mechanisms to cope with the swings of international liquidity.

• If a greater space for the coordination of the fiscal policy is generated, it could benefit the member states. The studies show that the correlation of the fiscal results across countries in the region is usually low and that the fiscal policy in these countries is highly pro-cyclical. To progress in fiscal agreements at a regional level could help create automatic stabilizers which do not currently exist.

• The national financial systems show deep failures that negatively affect not only domestic intermediation but also a potential regional integration of the financial markets. The MERCOSUR countries would have to make further efforts to obtain greater integration based on specific objectives like the creation of institutions for macroeconomic cooperation along the lines of the CAF and the FLAR.

• The improvement in the overall macroeconomic situation opens new opportunities for regional integration. The present situation could increase the region’s intra-regional trade, as happened in the nineties, but in a better context given the lack of external vulnerability. In recent years, the two largest economies in the region have presented external surpluses, whereas the other four are experiencing fiscal surpluses.
• The new macroeconomic situation in the region increases the space for the coordination of economic policy in the MERCOSUR. The return to the growth path and the generation of “twin surpluses” represent an opportunity to advance in the agreements on regional integration in all the topics mentioned above (real, monetary, fiscal, and external).

Finally, these results like many of the topics examined in the Net have been in line with the evolution of the institutional agenda of the MERCOSUR. Take the Macroeconomic Monitoring Group (GMM), an organization comprising high-ranking government officials from central banks and economy ministers from all the MERCOSUR and associate countries. As we explain in detail in Box 2, the GMM was established with the goal of advancing in macroeconomic coordination, with special emphasis on the monitoring of the fundamental macroeconomic variables and the generation of mechanisms to avoid crises and smoothing aggregate fluctuations, such as targets for the external debt / GDP ratio. In that sense, the work of the Net, fully inserted on the agenda of the MERCOSUR, contributes unambiguously to the institutional evolution of the region, in some cases generating new “points of view”, thus covering “empty” spaces generated by the institutional underdevelopment of the region.

In what follows we discuss the evidence behind these considerations in more detail.
Box 2 / Building institutions in the MERCOSUR: the case of the Group of Macroeconomic Monitoring

In the XVIII meeting of the Council of the Common Market 29 June 2000 the Group of Macroeconomic Monitoring (GMM) was created. The GMM has the following founding tasks:

“...• To elaborate harmonized statistics regarding public finances and prices on the basis of a common methodology.
• To publish the fiscal indicators on a regional basis.
• To establish fiscal goals for public debt and prices decided on a regional basis, as well as to design the process of corresponding convergence.
• To finish and update the survey and the comparative analysis of the effective norms applied in financial and capital markets, including the payment systems between countries with the goal of improving the integration of these markets.”

The GMM later evolved in three ways: the definition of convergence goals, the harmonization of statistics, and institution building. With respect to the first, mechanisms of convergence for the above macroeconomic variables were settled. During one first stage - the “transition” stage - the countries had to fit their accounts before the second stage could begin - of “common goals” - where targets were defined for the variation of the net fiscal debt of the public sector (3%/3.5% of the GDP as of 2002), for the ratio of public debt net to international reserves to GDP (40% in 2010) and for inflation (5% in 2002-2005, 3% as a trend thereof).

With respect to the harmonization of statistics, quarterly meetings have been held in which those in charge of each country present the progress and difficulties of the process. By the end of 2007 important advances had been made in Argentina, Brazil, Uruguay, Paraguay, Venezuela, and Chile relative to monetary statistics, and for all the countries with the exception of Venezuela, important improvements were made regarding the other topics (fiscal, debt, and prices).

With respect to institution building, perhaps the most outstanding case is the monetary institute of the MERCOSUR. In 2003 an intense debate arose over the creation of this institute. The primary goals of its original idea was to propose the general agenda for a monetary cooperation in the MERCOSUR, to discuss the creation of a regional currency that would serve as means of payment, to facilitate the compensation of balances of the central banks of the member countries, and to make research tasks in macroeconomic subjects oriented to the monetary and financial stability of the region.
When the Net was created in 1997, intra-regional trade was expanding strongly, the economies were growing at high rates and the policy makers envisioned the MERCOSUR as a beneficial option to integrate with the world and solve their fragility problems. Additionally, the European monetary unification exerted a strong demonstration effect so that the issues of interdependence and the coordination of economic policy took priority on the research agenda.

What effects did increased regional trade have at the national level? Our research detected increases in openness, together with greater demand spillover effects between the countries. The idea is simple. The econometric studies demonstrate that income effects are much more important than price effects in explaining factors regarding regional trade. With respect to policy recommendations, this fact supports the idea that the best exchange rate regime is that which guaranties the sustained growth of each country’s effective demand because it has a positive effect on regional trade for all the countries of the region. Thus, for example, Brazil’s steady growth is a powerful incentive for Argentine exports, even when the exchange rate is favorable to Brazil.

We also detected an increase in the contribution of the intra-industrial trade to total trade. This fact particularly affected the small countries, which experienced a deep change in their specialization pattern, provided that regional trade stimulated sectors that were not competitive with respect to the rest of the world. Take Uruguay. Our studies indicate that Uruguayan foreign trade has two components: one that has to do with the region and another that has to do with international markets. Trade with the latter is an accurate reflection of its productive structure and the traditional comparative advantages of the country. In the trade with Argentina and Brazil, however, other sectors appear as exporters that are not competitive in international (world) markets. These differences are more accentuated in the trade with Argentina; note in this case major levels of variability in the composition of the exporting flows. The sectoral diversification of the Uruguayan manufacturing exports has increased steadily from 1988, basically as a result of the behavior of the exports to Brazil. Despite this duality generated in the foreign trade, countries found significant opportunities to exploit their natural comparative advantages.

What happened to interdependence? The growth in regional trade increased interdependence, which would seem to have bolstered the synchrony of national business cycles. In order to study this point, in a past investigation we used a battery of econometric techniques that allowed us to decompose the business cycle of each country in two parts: a common one, shared with the rest of the region, and an idiosyncratic country-specific one. Specifically, we analyzed the cyclical co-movements between the main macroeconomic variables in the MERCOSUR countries, differentiating each economy’s specific shocks from those disturbances that influenced all the members of the bloc at the same time. Country-specific shocks that affected a particular economy...
could be related to the action of the domestic policies, whereas the common shocks were related, for example, to the macroeconomic situation in third party countries (for example, a recession in the industrialized countries) or with changes in the conditions for access to international capital markets (for example, the interruption of financial flows to emerging countries). The propagation mechanisms, on the other hand, are important because a shock that is initially country-specific can have spillover effects on the other countries. In the study we have detected that the country-specific (or idiosyncratic) business cycle accounts for a great part of the total variance of output. This low synchronicity is related to a fact that soon - with the initiation of the crises - would be evident: it is not possible to evaluate the challenges in coordinating countries like Argentina and Brazil without including their history of high inflation and high real volatility in their incentives. We find that the common component of the business cycle is related to matters of financial and real integration, like the evolution of country risk.

With respect to the evolution of the macroeconomic fundamentals, the research approached both fronts: the public sector and the external sector. With respect to the former, we studied the co-movement of the fiscal accounts. There we detected that the correlation between Argentina and Brazil is low. We also studied in detail the cyclical properties of the fiscal accounts of the MERCOSUR countries, detecting that both expenditures and revenues are volatile and highly pro-cyclical. When considering each country in isolation we observed that Brazil, Argentina, and Paraguay have had greater revenues and expenditures volatility. All this evidence favors the hypothesis of the absence of automatic stabilizers in action and opens up a space for cooperation in the fiscal spheres of the countries of the region. Additionally, we concluded that the management of fiscal policy in the great economies must consider the spillover effects that they cause on the small economies. Nevertheless, we also observed that in the case of Brazil and Argentina, the capacity to generate coordination policies is limited for two main reasons: the fragility of the fiscal accounts and the lack of efficiency of the fiscal institutions.

With respect to the external accounts, in a set of studies we examined the co-movement of the terms of trade for Argentina, Brazil, Paraguay, and Uruguay. We concluded that there is a low correlation between them and that a good part of it is explained by the cross correlations derived from international trade. Thus, gains of macroeconomic policy coordination in trying to reduce external vulnerability have not been fully taken advantage of. We also see a low correlation between the current accounts of the balance of payments, which reveals active idiosyncratic elements. Brazil and Argentina could manage their exchange rate regimes so as to allow their currencies to float when these types of shocks occur, thereby promoting trade and financial integration and maintaining their competitiveness with respect to third party countries.

The last line of investigation associated with the questions of this stage is related to the possibility of creating a monetary union. Our studies find diverse reasons for which
the region at that time was not prepared to face a monetary union. We mentioned two obstacles in this regard. On the one hand, requirements did not exist for institutional and macroeconomic terms that would promote the creation of agreements regarding the evolution of the fundamental macroeconomic variables, such as the fiscal result and the current account. On the other hand, the studies mentioned the low synchronicity of business cycles and the high volatility present in each economy.

We also evaluated the suitability of monetary agreements in the MERCOSUR, taking into account not only economic motivations but also motivations that have to do with the polity. We built a model contemplating the dynamics of three economies: two big economies and a small one. To calibrate the model we used data from Argentina, Brazil, and Uruguay. The distribution of power could be realized in equal parts between the countries, or according to their relative size (the GDP, geography, or inhabitants). Starting from different alternatives for the distribution of the power, we discussed what the consequences could be of the different options from monetary cooperation in terms of price stability and the variability of the levels of activity for each of the participating economies. The main conclusions of the analysis are that the polity has a very important role in the economic decisions and that power asymmetries must be incorporated into the analysis. In fact, although we saw that a greater cooperation between Argentina and Brazil benefits Uruguay, we also found that, after controlling for different scenes from monetary policy coordination, the most favorable situation for the small economy is that the distribution of power in the common instances is egalitarian for the three countries.
Brazil's devaluation in 1999 and the crises of Argentina and Uruguay at the beginning of the present decade substantially changed the objective of our research. In fact, the region shifted from a high growth/increasing regional trade regime to another where trade was depressed vis-à-vis GDP. Before this situation the coordination incentives had fallen. The policy agenda, which before the crisis had included issues of greater integration and coordination, changed to a purely idiosyncratic question: how to isolate the economy from the swings of international liquidity.

Against this background, the Net's research also underwent a deep change. From discussions on stability, coordination, and fine tuning, we shifted to the study of the "hows" and "whys" of macroeconomic crises and which regime changes were being developed. At the center of the debate was, of course, the rupture of the system of stable exchange rate regimes and the rise of a heterogeneous set of policy responses that, for the sake of gaining flexibility in an uncertain context, generally went unannounced by the monetary authority.

With respect to the crises, we conducted case studies of Argentina, Brazil, and Uruguay. In the study on Argentina we found evidence that supports the basic hypothesis that the convertibility regime implemented in the nineties became unsustainable because the solvency of key aggregate agents' balance sheets was called into question. We obtained similar results for the case of Brazil, whereas for the case of Uruguay, we detected the importance of spillover effects from the Argentine financial system to the Uruguayan financial system to explain the collapse of the latter.

With respect to the characteristics of the new regimes, we also used the case study methodology. For the Argentine case we detected that from mid-2003 the government determined a set of macroeconomic policy priorities: (a) maintaining a de facto regime of competitive real exchange rate; (b) fulfilling the monetary program and (c) accumulating international reserves and a reduction in external debt.

In January 1999 Brazil adopted a floating exchange rate regime. With the later implementation of the inflation targeting regime, the design of the "new model" of economic policy was completed with the generation of a high government primary surplus. Additionally, in this new monetary and exchange rate regime, the interest rate would be the main instrument to control inflation whereas the floating exchange rate would serve to close the external gap.

In the Uruguayan case the monetary policy that had been constructed after the 2002 devaluation shows a convergence towards an inflation targeting regime. In the facts we can distinguish four stages in this process. The first stage, which extended only for some months, was characterized by the nonexistence of a monetary anchor. During the second stage, which began at the end of 2002, the monetary base acted as the nominal
anchor of the system. The third stage, which began in 2004, was characterized by a higher commitment to control inflation. This greater commitment was reflected in the transition from a strict monetary target to a monetary band target. Finally, the last stage began in mid-2005 when the monetary base ceased to be a formal target. Inflation became the primary goal, but not all the requirements could enable Uruguay to implement an inflation targeting regime.

Finally, our empirical results reveal that Paraguay showed a predominance of the fixed or crawling-peg exchange rate regimes during the nineties, whereas since the year 2000 a change has taken place towards a greater flotation of the national currency. Nevertheless, this last stage has been characterized by a central bank decision to intervene in the market to reduce the fluctuation band width. From these findings, our research clearly shows that the Central Bank of Paraguay, fearful of not being able to fight the effects of high exchange rate volatility, has maintained strong control of the exchange rate.

Although all the countries announced full flotation of the currency after the crises, the results that emerged from these studies show that Brazil and Uruguay opted for regimes nearing the paradigm of a flexible exchange rate, whereas Argentina and Paraguay seem to be located within the broad group of emerging economies that practice hidden administrative forms of the exchange rate.

In conclusion at this stage, it is interesting that these options largely reflect the institutional specificities and the challenges that each country had to face after the crisis. Thus, whereas in Paraguay the de facto decision to stabilize the exchange rate was related to the high vulnerability of public and private sectors and to a high pass-through of devaluation to inflation, Argentina targeted high competitiveness and lowering external indebtedness. Brazil and Uruguay, however, had to reduce nominal volatility and that is why they focused on inflation targeting.
Since the consolidation of the post-crisis macroeconomic regimes, the situation has changed substantially in the international and regional scenes. These changes are related to two central aspects: the return to the growth path and the twin surpluses (fiscal primary and external). The first is important because it creates more space for policy making and extends the planning horizons for economic policy. The second is important because the coexistence of economic growth and a healthy macroeconomic environment opens the door to new challenges for economic policy and demands a new heretofore unexplored line of research.

With respect to the challenges, the twin surpluses have given rise to complex questions, such as the design of counter-cyclical policies for the management of macroeconomic risks. With respect to this, the governments have been following a self-protection policy through the accumulation of international reserves, which has effects on the real exchange rate and foreign trade. Nevertheless, we know little about these kinds of questions insofar as much of the stock of academic knowledge refers to a situation (the nineties) that was completely different in terms of the nature of shocks and propagation mechanisms (that is, financial shocks in the presence of high external and fiscal fragility, and the reform process).

In 2007 the Net worked on a project that, taking the international liquidity which the MERCOSUR countries had at the moment as an input, studied the possibilities for regional financial integration and the creation of instruments or financial markets. The financial sphere was chosen for three reasons. First, finance helps to transfer resources over time and through different states of nature, the reason for which its use can help to reduce macroeconomic volatility. Second, once the growth goal has been reached, finance can help in the development goal. Third, it is necessary to study whether national financial systems' failures can be reduced by means of financial complementation.

With respect to Argentina we found that during the financial globalization stage - particularly in the nineties - the financial linkages increased with the rest of the world and its domestic financial system was liberalized. Nevertheless, we cannot say that solid financial institutions to foster sustainable economic growth have been developed; in fact, the failures in the domestic financial architecture that we have detected (low financial deepening, high currency mismatch, high counterpart risks, the short duration of contracts, high concentration, low diversification of instruments, and so on) and the lack of fully financial integration (especially in the MERCOSUR) have given rise to a very fragile financial system.

In the case study dedicated to Uruguay we could detect the problems and restrictions that the national financial system displays and indicate that it has to do with financial underdevelopment, coupled with the extreme dependence on and the vulnerability of
the Uruguayan economy to international financial flows. Our research also shows that this feature was a key factor to explain the marked fluctuations of the economy and its low average growth. Our research allowed us to characterize the Uruguayan financial system as underdeveloped, with deep efficiency problems according to international standards, problems shared with the other MERCOSUR partners. The financial underdevelopment is reflected in the basic features of the system, in particular, the virtual nonexistence of markets. This last factor almost exclusively operates with public bonds and offers no real alternative of financing to the private sector.

With respect to Brazil, we studied the opening of the capital account and the evolution of the Brazilian financial system over recent years. In a situation of macroeconomic stability and a return to economic growth, capital markets have grown strongly and new instruments to develop resources have appeared. Nevertheless, some distortions inherited from the periods of instability and high inflation still remain, such as, excessive government participation in the financial markets, both in regulation and in the allocation of funds.

From this set of case studies and an additional comparative study, we obtained a list of stylized facts on the financial systems of the MERCOSUR.

- The financial systems of the MERCOSUR have a level of development that is smaller than what would be possible based on the GDP per capita of the region.

- National financial systems in the MERCOSUR are based on banks more than on markets. Nevertheless, in Brazil and in Argentina the development of the bond and capital markets is not so bad in relative terms. A segment that is particularly weak in all the countries is the segment of private or corporate bond markets.

- The countries under analysis display high levels of opening of the capital account and, in general, do not discriminate against the foreign capital in the banking system (although Brazil shows limitations).

- The financial flows intra-MERCOSUR is very low. Argentina and Brazil as larger countries invest outside the country. But neither of them invests significant sums in assets of the MERCOSUR countries.

- Episodes of financial turbulence originating in domestic macroeconomic imbalances and external financial shocks are important factors to explain the low level of financial depth since the effects of turbulences tend to be persistent in time.

These issues at this time, as well as the structural deficiencies reviewed in the case studies, together with the fact that other regions show significant advances in financial cooperation, suggest that the MERCOSUR would have to explore alternatives for financial
integration that have to do with “outside the border” policies - that is, integration with the international markets and the management of aggregate risks - but also with “inside the border” policies - that is, failures in domestic financial architectures.

With respect to the first question, evidence suggests that the MERCOSUR would have to evaluate seriously the proposal to create a regional reserve fund. In relation to this, our research indicates that the fluctuations in the bloc have an important common component and that this component is correlated with the changes in the global financial scenario. But those studies also mark the relevance of the idiosyncratic component of national business cycles. This last one suggests that there would be room to diversify risks. The bloc could seek to establish broader reserve funds agreements. The natural candidate is the Latin American Reserves Fund. An important obstacle is the issue of moral hazard. To cope with it, the conditionality of the extended fund could be designed and managed at the regional (that is, MERCOSUR) level. The MERCOSUR as a whole would establish a guarantee against the use of the reserves by any its members but would also establish the macroeconomic conditions for fulfillment for the region.

For sure, given today’s situation of the current account surplus, the creation of a fund does not solve the problem of how to use excess savings over investment. In relation to this, the MERCOSUR could only be helpful if it works “inside the border”, contributing to the creation of mechanisms for the efficient connection between savings and investment and to the development of financial instruments that would expand the transaction scale and include exchanges between varied contingent states of nature. To accomplish this goal, it is vital to create new channels for the use of the external assets that are accumulated, including those that are part of the private sector portfolio, which in the current situation are invested in external assets with very low yield.

In this regard, a natural option is the creation of a regional bank or agency for regional financing, like the Andean Development Corporation and the Central American Bank for Economic Integration. A regional institution could help identify investment projects defined by its regional interest, thereby facilitating deeper integration. Infrastructure for improving trade competitiveness and the support of initiatives for a regional innovation system are obvious candidates in this sense. The existing initiatives to favor the smaller countries could also be developed.

Another option for working “inside the border” consists of the use of excessive international liquidity to create new financial markets. In Asia, for example, a series of proposals has recently been put into practice specifically destined to create financial markets, focusing on the national and regional bond markets. The central goal is to avoid the prominence of short-run dollarized bond issues with the hope that it will contribute to preventing crises. The central banks dedicated a fraction of their international reserves to buying government bonds - in foreign currency as well as in
local currency - with the intention of extending the scale of the markets, increasing their liquidity, and creating regional indices for the bond market.

Finally, the MERCOSUR does not have to force the way to regional financial integration since the tasks of institutional building are complex. In fact, it could begin by creating an institute for financial cooperation whose first task would be to establish an agenda of feasible intermediate goals based on the recent international experience. Also, it could study ways to adapt the recommendations for better practices and standards and codes to the context of the MERCOSUR and, on that basis, seek normative harmonization and the design of a practical agenda of "inside the border" and "outside the border" actions.
II. THE RESEARCHES ON TRADE POLICY IN MERCOSUR NETWORK

In the period before the Ouro Preto Agreement (1988/94), despite frequent changes there was an economic policy decision in Argentina, Brazil, Paraguay and Uruguay, oriented to trade liberalization. This started as unilateral liberalization, followed in mid 1991 by trade liberalization within MERCOSUR, which provided reciprocal access to the markets of the partner countries.

Starting in 1995 the Ouro Preto Agreement added several instruments aimed at perfecting the trade union, some of them announced in March 1991 when the Asunción Treaty was signed. It was about free trade within the region and a common trade policy with third countries. A common trade policy is the combination of a Common External Tariff (CET), tariff revenue distribution criteria, classification and valuation of goods at customs, concession of common preferences to third countries, and common special import regimes, as well as common instruments of commercial defense.

In the research work done within the MERCOSUR Network (the “Net”, thereafter), tariff and non-tariff instruments, their relationship with economic growth and institutions were considered, and in this stage also trade in services. In the last few years, in the context of several events which inhibited the completion of the agenda, plus the existence in the MERCOSUR countries of special and preferential, not harmonized trade regimes, far from the objective of a Customs Union. Those deviations generated indirect restriction effects in intra-regional trade, together with not harmonized instruments at customs, technical regulations, fiscal aspects and instruments of trade defense. The results of the research, in addition to its academic contribution, could be used to rationalize the Common Trade Policy, specifically for the negotiation of a new Common External Tariff.
1.1 Evolution of tariffs, deviations from the CET and special regimes

Since the signature of the Asuncion Treaty, the objective of MERCOSUR was to establish a Customs Union as a part of a Common Market. MERCOSUR adopted the context of a Customs Union as a structure of economic integration. In comparative terms, considering the number of active trade preferential agreements registered in the World Trade Organization (WTO), the Customs Unions are a reduced number, given the higher level of compromise required among their members, due to the need of developing common policies and institutions. But choosing such type of trade integration was consistent with the ambitious objectives of the early treaties among the countries of the Southern Cone.

We could identify two stages in this process: the first, 1991-1994, the agreement was based on intra-regional trade liberalization. A schedule of tariff reduction, linear and automatic, was established with an objective of reaching 100% of tariff preferences in intra-regional trade. In the second stage, started in 1995, the country members agreed on two aspects: to continue in intra-regional trade liberalization, and to start the construction of a common trade policy vis-à-vis the rest of the world by designing a CET.

To that extent, in 1994 a new schedule of tariff reductions was approved (The Adequation Regime of MERCOSUR), excluding from this process, as in the first stage, two sectors: sugar and automobiles. The latter is still regulated by bilateral agreements despite of the existence of a common automobile policy in MERCOSUR. About sugar, the governments intended to include it starting in 2001, but it was postponed and has not been included yet. In addition to the remaining exceptions to intra-regional trade liberalization, several types of non-tariff barriers have restrictive effects which have been researched by the “Net”.

Concerning the construction of the Customs Union, in 1994 a CET and a pattern of convergence of the national trade policies towards the common trade policy of the block was established. The CET has a rate structure of 11 levels, with tariffs varying from 0% to 20%. The tariff rates increase as a function of the degree of fabrication of each product. The higher tariffs corresponded to consumer goods, in the other end are raw materials, and in between are intermediate inputs. The convergence was based on two instruments: sectoral lists (Lists of Capital Goods and of Informatics and Telecommunications Goods), where tariff preferences with third parties were different among countries and a convergence path was agreed towards the CET; and the national lists, including goods where the countries could stand aside of the CET. The convergence process expected to be finished by 2006 was not carried out in time, and was subject to successive postponements.
By the end of 1997 an increase in the CET of 3% took place, several goods were excepted of that increase, and each country had the option to do it in a different way, this increase was reverted in 2004. During some years a process of very gradual reductions of the CET was taking place, by increasing the frequency of items with zero tariff rates. However, in 2007 a new reversion took place increasing the tariff rates of 3 sectors (Footwear, Apparel and Textiles) to the level consolidated in the WTO. This increase was not applied in the same way by all the countries, thus another source of deviations in the national trade policies took place, relative to the common trade policy.

Summarizing, similar to the exceptions to liberalization of intra-regional trade, one finds exceptions to the implementation of the CET. Those exceptions could be grouped in six lists of products or each country: Capital goods, Telecommunications and Informatics, National lists; Sugar; Automobiles; Sensitive products (Footwear, Apparel, Textiles). The implementation of those lists resulted in a deviation between the CET and the national formal tariffs of each country member. In less than ¾ of the tariff universe, covering half of trade with third parties, the CET and the national tariffs are the same (degree of compliance) in the four country members.

If instead of comparing the CET and the national tariffs, a comparison is made between the national tariffs and the tariff effectively applied (tariff revenue/import value), the level of deviation is higher. For those goods were the tariff is higher than zero, the degree of compliance is only 10%. The basic sources explaining this high degree of non compliance are: different trade preferences with third markets, and special trade regimes not harmonized.

In MERCOSUR, common negotiations with third countries have been developed with more intensity in the last 10 years, but the outcomes stand aside of the general orientation of an open regionalism. The news about the agreements show that a preferential negotiation of the type South-South (among developing economies) restricted to goods was made, and more of a bilateral type than a common one; i.e. with differentiated incentives among partners vis-à-vis third countries, but has not been set in effective commercial agreements. This type of bilateralism is justified by different ability, interests and the specific situation of each partner, but is not consistent with the aim of constructing a Customs Union and the common disciplines which this project implies.

In Box 1 a summary is provided of the evolution of the different subjects related to tariff preferences in intra-regional trade, as well as about the construction of a common trade policy.
# BOX 1 / Liberalization of goods in MERCOSUR

<table>
<thead>
<tr>
<th>STATE OF THE AGREEMENT</th>
<th>STATE</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Start liberalization</td>
<td>1991</td>
</tr>
<tr>
<td>• Preferences and exceptions</td>
<td>100% preference in all products, except automobiles and sugar. In the first, bilateral agreements are in force and a common automobile policy existed but was no internalized. In sugar, no agreement was reached in the negotiation.</td>
</tr>
<tr>
<td>• Intra-region Safeguards</td>
<td>Forbidden according to the Asunción Treaty.</td>
</tr>
<tr>
<td>• Antidumping</td>
<td>Applied also to intra-regional trade. Its removal is conditioned to implementing an agreement of competition policy.</td>
</tr>
<tr>
<td>• Non-tariff barriers</td>
<td>It is a source of uncertainty in trade relations.</td>
</tr>
<tr>
<td>• Common External Tariff</td>
<td>Started in 1995. It has 11 rates (between 0% and 20%). There are sectorial and national exceptions. A convergence process of the national tariffs to the CET was established. Convergence postponed.</td>
</tr>
<tr>
<td>• Relation with third countries</td>
<td>Common agreements with third countries, a bilateral structure predominates, with the exception of agreements with Chile and Bolivia.</td>
</tr>
<tr>
<td>• Special trade regimes</td>
<td>In process of harmonization, different instruments are applied. They are a source of deviation.</td>
</tr>
<tr>
<td>• Other instruments</td>
<td>In process: Common Customs Code; change in circulation rules and mechanisms for the distribution of tariff revenues</td>
</tr>
</tbody>
</table>

Source: elaboration based on research done by the "Net"
1.2 Circulation and Rules of Origin

In the last few years (2004-2007) a direction was established to MERCOSUR in order to start functioning as a Customs Union. In particular, progress was made related to the rules of circulation introducing the rules of free practice. The existence of different national tariff policies regarding imports from the rest of the world, has introduced some regulations in the agreement in order to control unwanted practices. The rules of origin should be applied in the cases where due to the convergence process or about the implementation of different trade policies, the lack of compliance with the CET is verified (see article 2 of the Decision 1/04 of the Common Market Council, CMC). But this norm also anticipated the possibility of the requirement of origin to the entire tariff universe; this was the practice adopted by all the customs of the regional countries, and recently this requirement was postponed until 2010.

The imposition of Rules of Origin is based on the need to prevent unwanted distorting behavior of economic agents; this would be the outcome of differences in national trade policies, or between them and the common trade policy. Those practices try to avoid the high tariffs and import from the country with a more open national tariff policy. The Rules of Origin allow for avoiding this effect, but the way in which they are implemented and the lack of coordination efforts among customs resulted in negative effects related to restrictions in intra-regional trade. In general, the existence of internal customs, which are required for the implementation of the rules of origin and the imposition of domestic taxes, allow for the generation of non-tariff restriction in intra-regional trade.

The changes proposed in Decisions 54/04 and 37/05 of the CMC imply a trajectory for the reduction of the negative effects of the rules of origin, and at the same time avoid the opportunistic behavior resulting from different national trade policies. They also constitute a useful instrument for the common negotiation with third parties, by allowing common preferences of 100% (zero residual tariff) to have since 2006, the quality of goods in free practice (free circulation) according to the definitions of the Decisions mentioned.

Given the difficulties related to carrying out the substantive requisites of the decision which approved the principle of free practice (common customs code, rule of revenue distribution, and to complete the convergence of common trade policy), it is improbable that progress would be made in modifying the rules of circulation in the next years, thus it is expected that this process will also be postponed. Some intent was made of allowing the small economies to advance faster, but this objective could not be implemented.

After a decade of having a CET, the degree of compliance of the national trade policies vis-à-vis the common trade policy is low. Thus, no compliance with the free universal
principle characterizing a Customs Union takes place, and the rules of circulation in intra-regional trade are those of a free trade zone. Some progress was made in establishing the principle of free practice, but its level of implementation is low.

1.3 The liberalization of services trade in MERCOSUR

The international trade in services has become a new and important subject. Since the 90s the negotiations of trade in services involved the WTO, the MERCOSUR and possible future negotiations, for example, MERCOSUR-European Union. The types of services are basically those considered similar to "trade in goods" related to imports, and those considered "factor trade" related basically to Foreign Direct Investments (FDI), which has an important role in those transactions. An important aspect of services is about information, given to the fact that services are intangible and their quality is known when consumed. The presence of asymmetric information implies the need of government intervention in order to reduce such failures in defense of the consumer; i.e. regulations have an important role in the functioning of those markets.

In several countries the service sector has an important share in GDP and employment. The services have been considered during a long time as non tradable, but, technological advances have allowed that a greater proportion of them became tradable among countries. The amount of services exported and imported as percentage of goods traded for a group of 30 countries, showed an increasing tendency since the 90s up to 2003. In the developing countries, the importance of services liberalization is basically related to a potential contribution to the economy of an efficient service sector, and of their increasing weight among the sectors leading economic growth. The domestic regulations could create barriers to competition, and the fact that barriers for services are the legislation and the administrative practices, makes it difficult to know the magnitude of protection provided by such regulations.

The research project was concentrated in two services, Telecommunications and Banks, which are generalized inputs of the economic activity, and where in addition, multilateral negotiations had a better outcome (see Box 2).

The complexity of identifying and quantifying the restrictions related to the mentioned negotiations has determined the need of rules. Thus, in the context of the General Agreement on Trade in Services (GATS), the applied rules were of National Treatment and Most Favored Nation. They allow to identify and quantify the restrictions, those established rules have determined reciprocity relations. In GATS four modes of services' supplies are included among members: i) from the territory of one to the territory of another (cross border supply); ii) in the territory of one to a consumer from another
(consumption abroad); iii) establishment of the supplier of one member in the territory of another (commercial presence); iv) presence of physical persons from one territory in the territory of another (presence of natural persons). The specific commitments are applied only to the list of services included by a country member. The article V of GATS provided the possibility of member countries of the WTO to participate in economic integration agreements which discriminate to providers of services from other countries.

In the Montevideo Protocol (1997), which guides the services negotiations in MERCOSUR, the principles used are similar to those of GATS, agreeing to complete such liberalization in a period of 10 years after the Protocol was in force by the end of 2005. The objective of the Protocol is to liberalize trade in services carrying out article V of GATS, indicating

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**BOX 2**

Mercosur Network's researches on trade in services

**STAGES OF THE RESEARCH:**

- To evaluate the liberalization of those services through the development of several indicators of restriction used in the specialized literature, corresponding to the country members of MERCOSUR. This was done in the multilateral context (General Agreement on Trade in Services, Uruguay Round and additional Protocols, as well as to the negotiations in MERCOSUR (Protocol of Montevideo, those of 1998 in force, and those of the Sixth Round, not in force yet). Due to their relevance, the measurements of the degree of liberalization of “Cross border supply” (imports), and “Commercial presence” (investments) were emphasized, with the objective of identifying the protective effect to Foreign Direct Investments, known in the literature of goods as “Tariff jumping”, related in the case of services’ negotiations providing lower liberalization to the first mode as compared to the second;

- To study in detail Telecommunications and Banks cases, with the objective of identifying the characteristics of market access (no discrimination to entrants to a certain market, of nationals or foreigners), and national treatment (no discrimination between nationals and foreigners), related to the national regulatory contexts, market structure, and sectoral performance; and

- To evaluate the potential gains of the services' liberalization program in the context of a computable general equilibrium model. This approach has the benefit of providing consistency to the analysis of changes related to the dismantling of different levels of restrictions regarding Telecommunications and Banks.
that the yearly and successive rounds of negotiations would be automatically incorporated. Thus, the definition of modes of supply, rules of access to the market and national treatment, are similar to those of GATS.
2.1 Non-tariff barriers

The trade dynamics, in the context of intra-regional tariff reduction, implied an increase of exports of trade partners and an increase in demands for protection of domestic producers competing with imports. The trade policy transition since the unilateral liberalization to the MERCOSUR agreement implied the elimination of trade restrictions among the country partners, which resulted in economic gains. For this reason the “Net” research analyzed the less visible frontiers affecting the free circulation of goods within MERCOSUR, some are related to customs, or technical regulations, others to government activity, either their purchases or the non-neutrality of consumption taxes.

The research done was a systematic analysis of some experiences of Argentina, Brazil and Uruguay concerning the imposition of non-tariff barriers to their exports to the region. In the first place, the barriers were identified, and then the welfare benefits related to the dismantling of such restrictions were estimated in the context of a computable partial equilibrium model. To do that a questionnaire was sent to Argentinean, Brazilian and Uruguayan firms exporting more to MERCOSUR countries, as compared with their general export performance, based on a detailed perception of the effect of 15 barriers concerning Sanitary, Technical, Administrative and Other restrictions. This allowed us to characterize them as generic or specific, stressing their relevance as a permanent or transitory trade barrier within MERCOSUR.

In addition, several case studies were made to complement that aggregate vision, some related to the compliance with national standards, which resulted in experiences similar to those taken place in the European Community, where the most important problems were related to the lack of information and experience, and to the delays in getting their approval by public offices in the country of destination of their exports.

Later on, the estimation of the excess protection of the non-tariff barriers were made for selected products, which indicated that the winners corresponded to domestic consumers and foreign exporters, vis-à-vis the effect of lower returns to domestic producers and the recipients of those rents. But the multiplicity of interests involved indicates that the political economy aspects of such adjustments require a complex process of negotiation within and among the partner countries.

Besides, when the instruments of trade defense were applied on imports originated from the trade partners, the demand for protection of the domestic producers has an effect equivalent to a non-tariff restriction inhibiting free circulation within the region. In such cases, some countries resorted to the Protocol to solve controversies; others, facing the imposition of antidumping taxes, signed price agreements.
It should be mentioned that most of the international harmonization and reduction of non-tariff barriers was done within regional integration processes, but in MERCOSUR this was slower. The experience showed that it is easier to agree among small groups about the convergence of objectives on standards, than at the multilateral level. To overcome the present situation, a negotiating attitude is required, which could encourage exporters to face institutional solutions to dismantle those barriers. Also, a compromise of the governments is needed, in order to start negotiations towards the harmonization of national asymmetric barriers.

2.2 Trade defense instruments

The CET of MERCOSUR was introduced in 1995 with exceptions, but up to now, except on safeguards, no harmonization of trade defense instruments was made, thus each country maintains its autonomy in the administration of such instruments. In this way when they are applied on imports from third countries, this represented a non-compliance with the CET, and when applied to imports from the region they implied barriers affecting the free circulation within the block.

The research project done about the instruments of commercial defense was in the context of a broader objective considering the route to the Common Trade Policy. This implied the analysis of the evolution of the CET, and its deviations, the special regimes, estimations of effective protection (it is the tariff incentives provided to domestic productions competing with imports, netting the inputs' incidence), computing the incremental effects of the instruments of trade defense and the cost of protection related to the existing restrictions.

The domestic political economy problems showed the difficulty of constructing a CET, but the MERCOSUR governments considered that the establishment of a CET and a convergence track was important. The flexibility of the governments applying the tariff policy resulted in discretionary deviations as compared to the agreement, and so a situation of lack of transparency. About the instruments against disloyal trade practices, the MERCOSUR countries have internalized the multilateral rules of the WOT, which, given their relative application permissiveness, could be used as a protective instrument, either towards the rest of the World and/or the MERCOSUR countries.

In the last few years, Argentina became very active in the application of trade defense instruments; if the value of imports is considered, Brazil and China are the most affected countries by antidumping measures. In Brazil, the demand of protection through trade defense instruments increased with tariff dismantling that started in February 1991 and concluded earlier than scheduled in July 1993. The most important countries affected by antidumping actions in force by the end of 2003 were China and the European Union. Uruguay made 3 antidumping investigations of products originated from...
Argentina. The *ad valorem* equivalents estimated of some of the specific items involved indicated the importance of their protective effects.

Thus, the harmonization of antidumping and anti-subsidies instruments has faced the opposition of the MERCOSUR countries wanting to use antidumping to protect their industries competing with imports from the region; also, that having a common normative might imply an increase in the requirements to be satisfied in the process of imposing such barriers. In this context, no progress was made by intending to increase progressively the requirements to impose antidumping and anti-subsidy measures in intra-regional trade.
It is known that trade openness favors the production of more efficient sectors and allows the access to new technologies through imports of machinery, equipment and inputs, resulting in an increase in productivity. Thus, the adoption of such measures in the countries of MERCOSUR generated expectation about the regional growth performance, encouraged by the empirical evidences showing that countries more open to trade had evidences of higher increases in GDP. But the rates of economic growth of the member countries of MERCOSUR in the 90s presented strong fluctuations, with stages of better performance related with successful periods of price stabilization, with frustration of initial expectations.

The increase in imports related to trade liberalization could also influence economic growth through the increase in productivity, related to the exit of less efficient firms and the access to new technologies embodied in capital goods and current inputs. This productivity increase implied, in its turn, an increase in exports. In fact, the share of trade to GDP increased between 1990 and 2003, from 12.6% to 20.8% for Argentina, from 13% to 33.4% for Brazil, and from 28.2% to 39% for Uruguay. Paraguay was the only block member with stable values, 64.1% and 60.1% respectively. For Brazil and Uruguay, there are strong empirical evidences showing a positive contribution of import liberalization on productivity, while those outcomes for Argentina and Paraguay are less important.

Also, increases were taking place, between 1989-1990 and 2005-2006, in the indices of intra-industry trade, which measures foreign transactions of similar goods imported and exported within the same sector (for example, exports and imports of automobiles), as a share of total sectoral trade, this increase was more important among the member countries of MERCOSUR. In Argentina the share of intra-industry trade with their partners increased from 32.7% to 44.4%; Brazil, from 25.6% to 43.4%; Paraguay, from 2.3% to 10.3%, and Uruguay, from 22.3% to 30.6%.

Since other factors are influencing the rates of growth, it is not easy to distinguish whether trade liberalization contributed effectively to a better performance of the economic activity. Recent studies mentioned that trade policy could contribute to economic growth, provided it is complemented with appropriate macroeconomic policies and an institutional context with adequate regulations, assure property rights and guarantee the compliance of contracts through an efficient judiciary system.

In order to evaluate the institutional evolution of MERCOSUR, 4 indicators of governability were estimated by the World Bank between 1996 and 2006. The “government efficiency”, that measures the quality of public services, degree of independence of public institutions facing political pressures, and the capacity of formulating and implementing policies and their credibility. The “regulatory quality”, that reflects the government ability of implementing policies to control and of market regulations. The “state of
law”, that measures the degree of confidence and acceptance by the agents of the established rules, and particularly the compliance of contracts and decisions of the judiciary system. The “corruption control”, which implies inhibiting the appropriation of public institutions to generate private gains, like corruption in politics, or the need to make contributions, to get or accelerate the procedures in public services. Also, the comparison of costs of foreign trade operation (number of documents and days needed, cost per container) was made by the World Bank in 2007 for 178 countries. The ranking showed that Argentina was in the 107 place, Brazil 93, Paraguay 123 and Uruguay 125; lower positions corresponded to other developing countries, like Chile 43, China 42, India 79, and South Korea 13.

The analysis of the evolution of the institutions between 1996 and 2003 showed that the indicators were constant for the 4 countries of MERCOSUR. As to the comparison of the costs of doing foreign trade business, the results indicate that no improvement seems to have taken place in the institutional context of MERCOSUR that could be attributed to a trade increase. However, in the context of this investigation, several important dimensions were identified in the experiences of the countries of MERCOSUR, about the interaction among the trade structures, indicators of productivity and regulatory issues related to the defense of trade and competition.
SUMMARY AND FINAL THOUGHTS

The advances towards a common trade policy and free circulation intra-MERCOSUR require the harmonization or elimination of mechanisms allowing unilateral deviations vis-à-vis the common trade policy. In that direction one could anticipate important difficulties, given the multiplicity of interests which could differ among countries. Concerning the non-tariff barriers, to dismantle them it is necessary to introduce institutional solutions by exporters and governments, thus starting bilateral and multiregional negotiations that remove, harmonize or have mutual recognition of the asymmetric barriers regarding certifications and national standards.

The gap between the CET and the Applied Tariff could be explained by the sectoral lists of Capital Goods, Informatics and Telecommunications, the National lists of exceptions and the existence of not harmonized sectors (Sugar, Automobile). The gap between the Applied Tariff and the Collected Tariff takes into account the preferential agreements not harmonized and a multiplicity of special import regimes. The downward deviations of the CET, which are the most frequent in MERCOSUR, are the outcome, basically, of special import regimes and exceptions to the CET; this could imply transfers of income among the members of the block as well as a lower level of protection than that afforded by the CET. The importance of the imports effectively channeled through those instruments generates uncertainty about the real levels of protection to regional producers. Thus, in the case of downward deviations, those which continue charging the CET have the incentive to establish non-tariff barriers; i.e. a link exists between the progress made towards free circulation and the elimination of the mechanisms generating deviations.

Also, non-tariff barriers to trade exist when a national producer has to change the product to fulfill the regulations of another country, or subject his product to tests and certifications in the importing country. The main causes of those barriers are compulsory government regulations, or voluntary standards that could be imposed by non-governmental institutions. Barriers on exports not anticipated, as well as ad hoc solutions introduce uncertainty, reduction of exports and cost increases related to the minimization of their impact. The systematic analysis of some experiences of non-tariff barriers higher than the CET, affecting exports to the region allowed us to characterize them, estimate their welfare effects on consumers as well as the foreign supplier, and illustrate the importance of dismantling them. In MERCOSUR, the only common instrument of trade defense is safeguards, no progress was made in harmonizing the instruments against disloyal trade practices (antidumping and export subsidies), or increasing the restrictions to impose them. This generates uncertainty to exporters, equivalent to the one related to non-tariff restrictions.

The analysis of the interaction among trade policies, growth and institutions provided important evidence related to the structure of trade, institutions of trade defense and competition, which identified several dimensions to take into account in the task of...
analyzing the compliance with the common trade policy. The project of services faced the identification, through the case studies of Telecommunications and Banks regarding market access and treatment of foreign capital. The case studies referred to stressing the importance of their regulatory context, and the specific aspects of the market structure and performance. Finally, a simulation was made of the effect of dismantling the existing restrictions on Telecommunications and Banks, within the framework of a computable general equilibrium model, which provided valuable information for the policy alternatives.
III. RESEARCHES ON FOREIGN DIRECT INVESTMENT IN MERCOSUR NETWORK

The impacts of Foreign Direct Investment (FDI) on the development objectives of host developing countries have been debated both in the academic as well as in the political arena in recent decades. The dominant thoughts on the subject have been changing through time, and those changing views have also materialized in MERCOSUR countries—especially Argentina and Brazil—.

In the first post-war years FDI was mostly perceived as a favourable element for developing countries insofar it was supposedly able to provide three factors which are often scarce in those countries: a) technology; b) capital; c) entrepreneurial capability. It comes as no surprise then to find that, for instance, Transnational Corporations (TNCs), which are the carriers of the bulk of FDI flows at world level, played a dominant role in import substitution industrialization (ISI) episodes in many developing countries.

This pro-FDI view began to change in late 60’s, when “anti-dependentist” arguments gained momentum, and in many cases influenced on the adoption of more restrictive policies towards FDI in those regions. The pendulum swung once more with the emergence of globalization. In the 90s open competitions or biddings for FDI were not unusual, even in developing countries. The rationale behind those competitions was that FDI was able to contribute with the reforms processes undertaken in those countries which were aimed at adapting the respective economies to the new reality of the globalization world.

Nowadays a certain consensus on the following argument has emerged: FDI, per se, is neither a panacea nor a poison for development. Its impacts depend on the nature of FDI inflows, the strategies and objectives pursued by TNCs when they invest in developing countries, the linkages they establish with domestic agents (firms, universities, etc.), the macroeconomic, institutional and structural conditions in host countries and the public policies in force in those countries.

Since MERCOSUR has attracted large FDI inflows over the last decade and a half -and in fact FDI has traditionally played a key role in MERCOSUR member countries-, it seems relevant to analyze the impacts of those inflows on the economic development processes of host member countries. This document aims at dealing with this analysis on the basis of the findings of a series of research projects on the subject that have been undertaken within the MERCOSUR Network in recent years.

2 The group that developed the researches on foreign direct investment included the following institutions: Centro de Investigaciones para la Transformación (CENIT) from Argentina; Instituto de Economía - Universidad Estadual de Campinas (IE-UNICAMP) from Brazil; Departamento de Economía - Facultad de Ciencias Sociales (DECON-FCS) from Uruguay; and Centro de Análisis y Difusión de la Economía Paraguaya (CADEP) from Paraguay.
Since its inception, MERCOSUR has been one of the main focuses of attraction for FDI within developing countries —between 1990 and 2005— the region attracted nearly US$330 billion of FDI. Argentina and Brazil received the bulk of those flows (graph 1).

Graph 1

FDI INFLOWS IN MERCOSUR, 1991-2006
(current US$ million)

Argentina and Brazil

Paraguay and Uruguay

Source: Own elaboration on the basis of UNCTAD data.
This FDI boom in MERCOSUR was part of a global trend. In 2000 world FDI inflows amounted to a record figure of US$ 1,400,000 billion. Although they later had a drastic fall, at present FDI World inflows are clearly above last decades’ averages and in 2006 they got close to the 2000 record.

Pari passu, the number of TNCs increased: while in early 90s it was estimated that there were 37,000 TNCs with at least 170,000 foreign affiliates, in 2004 the number of TNCs had grown up to nearly 78,000 and that of foreign affiliates to 777,000, almost half of them located in developing countries (UNCTAD, 2007).

The strong influence of TNCs in the world economy is revealed by the following data: i) it is estimated that a third of the world’s trade is purely intra-firm (that is among headquarters and affiliates of the same corporation) and another third corresponds to transactions between a TNC and an independent firm (although a large part of these transactions are with firms that have subcontracting relations with the TNC); ii) according to UNCTAD’s data, the 700 firms with higher R&D expenditures at world level (almost all of them are TNCs) explain half of the world’s total R&D expenditures and two thirds of the world’s private expenditures.

Within MERCOSUR, the presence of the FDI and the TNCs is also very important. The ratio FDI stock/GDP has been growing significantly and reached very high levels in international terms in Argentina and Brazil (table 1).

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Source: Own elaboration on the basis of UNCTAD’s data.

Expectedly, the massive FDI inflows led to a large expansion of the TNCs presence within the region during the 90s (graph 2), reaching levels that in the case of Argentina and Brazil rank among the world’s highest.®

Notes:
1. The growing TNCs presence in both countries gave place, at different moments, to reactions mainly coming from the private sector and the civil society against the “denationalizations” of both economies. However, these reactions rarely had practical consequences.
Graph 2
TNCS SHARE AMONG THE LEADING FIRMS IN MERCOSUR, 1992, 2000 and 2003
(percentages)

Number of firms (*)

Argentina Brazil Uruguay

43.8 63.6 68.0
29.4 45.8 44.6
28.0 41.7 37.7

(*) Number of TNCs affiliates on total leading firms in each country

Sales

Argentina Brazil Uruguay Paraguay

60.0 82.0 56.0 51.7 25.7 38.0
43.0 43.0 34.4 31.0 38.0 38.0
56.0 51.7 34.4 31.0 38.0 38.0

Notes: No data are available for 1992 in Argentina, hence 1993 data was included; TNCs' share figures are estimated on the basis of a universe of 500 leading firms in Argentina and Brazil and 300 firms in Uruguay; data for Argentina are calculated on the basis of gross production value instead of sales; no data are available for 2003 in the case of Paraguay.

Source: Own elaboration on the basis of the Encuesta Nacional a Grandes Empresas/INDEC (Argentina), Revista Exame (Brazil) and MC Consultores (Uruguay).

In this scenario, follow some questions about the main trends, features and attraction factors of FDI and the dominant presence of the TNC.
Both Argentina and Brazil have adopted, even since the agro-export model period, developmental strategies in which FDI played a key role. This role was reinforced during the ISI stage -especially from mid 50s to the 70s- when TNCs, jointly with State firms, led the transition towards heavy industrialization in both countries.

As a matter of fact, MERCOSUR countries as a whole attract nowadays a lower percentage of the world FDI than in the 70s (4% in the 90s against more than 5% in the 70s, when almost all FDI arrived to the region went to Brazil). However, measured in constant US dollars FDI inflows received in the 90s are six times higher than those of the 70s. This means that in a context of strong increase in world FDI flows, other regions (Asia) gained relative attractiveness vis a vis MERCOSUR.

**Table 2**

**ORIGINS OF FDI ARRIVED TO MERCOSUR, 1992-2004**

(percentages)

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<td>4.1</td>
<td>1.7</td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>-0.7</td>
<td>0.3</td>
<td>5.0</td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>n.a.</td>
<td>-</td>
<td>14.2</td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>-</td>
<td>0.4</td>
<td>10.2</td>
<td></td>
</tr>
<tr>
<td>Uruguay</td>
<td>n.a.</td>
<td>1.0</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Other countries</td>
<td>60.3</td>
<td>33.3</td>
<td>41.6</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

(*) Not available.

Source: Own elaboration on the basis of data from Dirección Nacional de Cuentas Internacionales (Argentina), Banco Central do Brasil, MC Consultores (Uruguay) and Chudnovsky -coord.- (2001).
Which were the sectors that attracted FDI in MERCOSUR? Services received the bulk of FDI in four MERCOSUR countries during the 90s (table 3). FDI in services was related with privatizations, but also with relevant investments in areas such as banking, wholesale and retail trade and others. Manufacturing industry received around 20% of total FDI in Argentina and Brazil, a figure well below that observed during the ISI. In smaller countries FDI in agriculture and related activities was relevant. In fact, this kind of “resource seeking” investment was also important in Argentina, where oil and mining received more than a third of total FDI arrived in the 90s.

Table 3
DESTINATION SECTORS OF FDI ARRIVED TO MERCOSUR, 1992-2004 (%)

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>n.a.</td>
<td>0.0</td>
<td>11.1</td>
<td>11.6</td>
</tr>
<tr>
<td>Oil</td>
<td>33.4</td>
<td>0.8</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Mining</td>
<td>1.3</td>
<td>0.7</td>
<td>5.3</td>
<td>0.0</td>
</tr>
<tr>
<td>Manufacturing Industry</td>
<td>22.6</td>
<td>18.0</td>
<td>22.8</td>
<td>43.6</td>
</tr>
<tr>
<td>Services</td>
<td>42.7</td>
<td>80.5</td>
<td>60.8</td>
<td>44.7</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

* Not available.

Source: Own elaboration on the basis of data from Dirección Nacional de Cuentas Internacionales (Argentina), Banco Central do Brasil, MC Consultores (Uruguay) and Chudnovsky — coord. — (2001).

As it was the case with global FDI inflows, mergers and acquisitions (M&As) channeled the bulk of FDI arrived to MERCOSUR. M&As in the region were not only related to privatizations, but also to a wave of acquisitions of private domestic firms both in Argentina and in Brazil.

The FDI boom in MERCOSUR during the 1990s was largely a reflection of a similar global trend. However, it was also related to internal factors, such as the size and growth of
the domestic markets of the MERCOSUR countries which coupled with export dynamics, macroeconomic stability and the availability of natural resources, especially in Argentina, Paraguay and Uruguay, was among the main factors attracting FDI to the region. On the contrary, labor costs did not play a role for FDI attraction.

Some policy instruments, including privatization, deregulation and trade liberalization, as well as debt-swapping mechanisms (used extensively in the late 1980s), had a positive effect on FDI inflows into MERCOSUR. Nevertheless, MERCOSUR's impact in attracting FDI does not appear to have been particularly significant, except in the automobile sector, where specific policies were applied in Argentina and Brazil. In other words, the impact of the integration process, in and by itself, was relatively minor as compared with other determinants of FDI attraction.

In the second half of the 90s a wave of incentives-based competition for FDI emerged in MERCOSUR. This competition took place through the granting by national, provincial and/or municipal States of fiscal, credit and labour subsidies, infrastructure provision, etc. to foreign investors. This phenomenon was particularly strong in Brazil and, to a lesser extent, in Argentina, and although nowadays it is less intense than in the past, if is far from having disappeared.

In the case of MERCOSUR, this competition resembles a zero-sum game, since investments that are “gained” by a country/province/city, are often at the expense of other MERCOSUR regions (i.e., no evidence exists suggesting that these incentives increase the total FDI arrived to MERCOSUR). Moreover, incentives often reinforce the attractiveness of already richer regions (since they are able to grant larger subsidies) and their concession has been seldom linked to goals other than investment and employment (the main exception is the electronics industry in Brazil, which receives subsidies in exchange of compromises in terms of R&D expenditures). Although some attempts to introduce disciplines in the use of incentives have existed, so far it remains as a pending issue in MERCOSUR’s agenda.

Which were the main objectives of TNCs investing in MERCOSUR? When a firm invests abroad it may look for different objectives. The more traditional motivations are: exploiting host countries’ domestic markets (market-seeking FDI) and accessing natural resources (resource seeking FDI). More recently, the search for efficiency through intra-firm specialization and trade networks became very relevant and gave place to the so-called efficiency-seeking FDI. Finally, TNCs may invest in order to capture key assets for their global strategies (strategic asset seeking FDI).

FDI in MERCOSUR has been mainly market seeking (both in services as well as in the manufacturing industry). Resource seeking FDI has been relevant in Argentina, Paraguay and Uruguay.
4 Since the 90s, the global strategies of the main world car producers were increasingly based on regional production and distribution centres which belong to internal networks in which automobiles and parts produced on those centres are traded. MERCOSUR is one of those centres.

5 These are strategies in which the TNC affiliate has a direct access to the world market, undertake R&D activities and has the power to make decisions in terms of product updates and global marketing.

Efficiency seeking FDI has been observed in some sectors, triggered by the dismantling of tariff barriers in MERCOSUR, which allowed TNCs to adopt product and trade specialization schemes among its affiliates in the region. The automobile industry is the best illustration of the deployment of these strategies. Although free trade within MERCOSUR does not exist for this sector (see below), specific policies were adopted in Argentina and Brazil inducing affiliates in the region to specialize in certain product lines. This change was also favoured by the fact that global strategies of large TNCs that dominate this sector at the world level went in the same direction. In this way, a regional labour division pattern emerged, in which Argentinean affiliates produce low-volume models and Brazilian firms produce high-volume ones, in both cases complementing local supply with imports from third countries.

It is revealing to compare the FDI pattern in MERCOSUR with that observed in Mexico and the Caribbean. In those regions, FDI has been mostly efficiency seeking, mainly destined to the industrial sector and undertaken by American TNCs that look for cost reductions -especially labour costs- in order to develop export-oriented labour intensive activities in the context of global intra-firm specialization schemes. The main impacts of this kind of FDI have been in the employment and export areas, while it has seldom generated positive contributions in terms of backward linkages or domestic technological development.

Summing up, in contrast with the trends observed in Mexico and the Caribbean, FDI in MERCOSUR during the 90s was -with some exceptions- weakly articulated within the international production systems of TNCs investing in the region. The dominant logic in the case of FDI arrived to MERCOSUR was of national/regional nature.

It is important to highlight the fact that FDI patterns within MERCOSUR have been far from being uniform. For instance, while it has been seldom the case that TNCs affiliates in MERCOSUR get the so-called “world product mandates”, there are some examples of these mandates in Brazil, since in that country TNCs have installed product development centres in sector such as automobiles, auto-parts and telecommunications equipment. In the same vein, it has been stated that Brazil has become a sort of “lab” for organizational changes in the automobile industry (e.g. plants modularization). No similar cases are known in Argentina, Paraguay or Uruguay.

Furthermore, according to UNCTAD’s data, Brazil is within the list of top localizations preferred by TNCs to decentralize R&D activities, while the other MERCOSUR member countries do not appear within that ranking. All these data suggest that FDI in Brazil followed a different pattern vis a vis those of other MERCOSUR member countries.

What happened with FDI arrived to MERCOSUR during this decade, after the break of the world’s FDI growth cycle in 2001 and the severe crisis suffered by Argentina...
Uruguay in 2001 and 2002? Graph 1 shows the dramatic fall of FDI inflows arrived to MERCOSUR after 2000—this was particularly notable in Argentina—.

The rationale behind the lower attractiveness of Argentina for FDI reception is quite clear. In late 1998 a long recession began in that country, which ended in 2001-2002 with the worst crisis in Argentina’s history, including a mega-devaluation of the peso—ending with the Convertibility regime—, the default of the external debt and the collapse of the banking system. In 2002 real GDP decreased by more than 10%.

The end of the Convertibility programme went hand in hand with severe conflicts between foreign investors and the Argentina’s government, mainly in two areas: a) the financial system: here the problems arose due to the need to compensate to the banks for their losses after the “pesification” of US dollars nominated deposits and credits; b) privatizations: as privatized public services tariffs (which were originally nominated in US dollars) were converted into Argentine pesos and then frozen, a large number of foreign investors filed demands against Argentina before the ICSID (International Centre for Settlement of Investment Disputes) -Argentina became the country with more demands before the ICSID, with 40 cases over 183 by mid 2005-. Although some investors have withdrawn their demands, tariffs increases have taken place at a very slow pace, which led many foreign firms to leave the country, selling their shares to local investors or investment funds. Some foreign banks have also disinvested in Argentina, although few of those cases happened and in most cases they corresponded to small size banks.

In the new scenario, the pattern of origins and destinations for FDI also changed (tables 2 and 3). On one hand, it is observed that FDI from developed countries is clearly less relevant than in the 90s, while investments from Brazil—mainly channelled through M&As—strongly increased. On the other hand, and expectedly after the peso devaluation and the freezing of public services tariffs, FDI in tradables increased its relative share, while services share on total FDI passed from 43% to 27% between 1992-2000 and 2001-2004.

In contrast with the Argentine case, in Brazil there were no such dramatic changes in FDI trends. In fact FDI inflows grew steadily between 1995 and 2000 in spite of the 1999 crisis which lead to the Real’s devaluation. The FDI fall in 2002-2003 took place in a context of deterioration of the macroeconomic climate, with low growth and increasing inflationary pressures. The reduction of investment opportunities in privatizations was also a factor explaining the decrease in FDI inflows. In turn, FDI recovery after 2004 took place in a scenario of improving macroeconomic indicators.

Regarding FDI origins, the United States jointly with some European countries are still leading the ranking (table 2). In the case of FDI destinations, and similarly to what happened in Argentina, once privatizations were over, the weight of the manufacturing
industry on total FDI grew significantly vis a vis the 90s (41% vis a vis 18 per cent) –table 3–.

Some acquisitions of foreign affiliates by local companies ("renationalizations") have also been recorded. At the same time, some Brazilian companies have deepened their processes of productive internationalization, being Argentina, as said before, one of the most important destinations of the new investments.

As for the MERCOSUR smaller member countries, during this decade both kept losing weight on total FDI. While FDI to Paraguay was clearly lower than in the 90s, the opposite happened in Uruguay. Argentina and Brazil are still important investors in the Uruguay's economy (table 2). In turn, and in sharp contrast with what happened in those countries, services' share on total FDI arrived to Uruguay in the present decade is higher than in the 90s (table 3). Investments in the forestry and pulp sectors have also been relevant—in the latter case two large investments, amounting to more than 1500 million US dollars and coming from Spain and Finland, have generated a serious dispute with Argentina around their potential negative environmental impacts—.
FDI may have large macroeconomic impacts on host countries, especially due to its potential contribution to gross capital formation and, hence, to GDP growth. In turn, FDI may also have relevant direct and indirect microeconomic impacts, mainly through the presence of TNCs on domestic economies.

TNCs affiliates enjoy “ownership advantages” thanks to their access to product and process technologies and to the organizational, production, business and environmental practices of their parent companies. Such affiliates — especially when they operate in developing countries — thus generally have advantages over their local competitors in terms of higher productivity and greater capacity for launching new products and productive processes on the market.

Furthermore, FDI can be expected to influence trade flows in recipient countries because subsidiaries are part of corporate networks which, theoretically, facilitate the exchange of goods and services with other subsidiaries, with the parent company and even with third parties (suppliers and others). With their higher levels of productivity and easier access to foreign markets, it is reasonable to assume that subsidiaries will have a greater propensity to export than local companies. And because it is easier for them to purchase from foreign suppliers, including both inputs and finished goods and capital goods, they will also, presumably, be more likely to import than local companies.

In addition to its direct effects, FDI also has significant indirect effects (also called spillovers) on domestic companies. In the area of productivity, for example, there may be positive spillovers for companies in the recipient countries, which may take various forms. For example:

- Human capital may be improved when local companies and institutions gain access to operators, technicians and engineers trained by TNCs affiliates.
- FDI may increase the level of competition on the domestic market, prompting local companies that compete with the foreign firms to boost their productivity and/or enhance the quality of their products, either by making investments or by taking advantage of knowledge that trickles down from subsidiaries - i.e., through horizontal or intra-sectoral spillovers.
- Local companies may benefit from the technologies and organizational practices of TNCs, both as a result of the more stringent demands for quality, price and/or delivery time that subsidiaries generally place on their suppliers and as a result of the technical assistance that they may provide in order to ensure that those demands are met - i.e., vertical or inter-sectoral spillovers.

While TNCs affiliates would have incentives for avoiding horizontal spillovers, they might be inclined to promote vertical or inter-sectoral spillovers. This type of spillovers will probably not have any adverse effect on the subsidiaries and indeed might well
benefit them by making their customers and/or suppliers more productive and more efficient.

TNCs affiliates can also generate positive spillovers in terms of access to external markets if their export activities reduce the cost of acquiring information on such markets or make it easier for local companies to learn to export.

However, spillovers will not always be positive. For example, productivity can be negatively impacted when local companies are forced to cut their production—thus lowering productivity in their establishments—in the face of a growing foreign presence in the market. Negative vertical spillovers can occur when, for example, local suppliers are displaced from the market as a result of subsidiaries' preference for foreign suppliers.

Which is the available evidence on FDI impacts in MERCOSUR?

- The macroeconomic impacts of FDI in MERCOSUR countries have not been significant, since its effect on investment and growth in the countries of the region was neither positive nor negative.

- TNCs affiliates are more involved in international trade than domestic companies, in terms both of imports and of exports. In other words, FDI and foreign trade seemingly go hand in hand in the case of MERCOSUR. A large part of TNCs affiliates' foreign trade is intra-firm (that is, it is made with the headquarters and/or with affiliates in other regions).

- At the same time, the participation of subsidiaries in the intra-firm trade of transnational companies shows some asymmetrical patterns. It has been shown that affiliates of TNCs headquartered in developed countries tend to import mainly from their countries of origin—but they do not show the same tendency with regard to exports—and that such imports had higher technology content than their imports from other regions.

- It can be concluded hence that there is a sort of intra-firm international "division of labor" in which TNCs affiliates operating in the region are involved. These affiliates mostly supply their respective host markets and other developing countries—especially in Latin America—with goods that have lower technology content when compared with those goods that affiliates import from other regions, especially from their headquarters and from other affiliates in developed countries.

- TNCs affiliates have higher productivity levels and higher capabilities for launching innovations to the market than their local competitors (although they do not spend more money on R&D, since they have access to the knowledge generated within their respective corporations). However, spillovers on domestic firms have heterogeneous signs and limited size.
• Domestic firms that supply TNCs affiliates have seemingly improved their productivity performance, which may be the result of specific efforts by affiliates in order to help their suppliers to get efficiency improvements.

• In contrast, horizontal productivity spillovers—i.e., spillovers between companies competing in the same area of activity—seem to depend on certain characteristics of the local companies and of the markets in which they operate. Generally speaking, no evidence was found of either positive or negative horizontal spillovers, although when various features of domestic companies were examined, some differential effects emerged. For example, in Argentina it was the domestic companies with the greatest absorptive capacity that most benefited from the presence of TNCs, whereas in Brazil the biggest beneficiaries were the domestic firms that had the largest productivity gap vis a vis the TNCs. While the finding in Argentina is presumably explained by the fact that greater absorptive capacity facilitates the transfer of knowledge from TNCs affiliates to local firms, the situation in Brazil appears to have more to do with the massive influx of market-seeking FDI, which displaced the local companies competing directly with foreign subsidiaries in the same markets.

• There is some evidence suggesting that negative productivity spillovers may arise when FDI is mainly market seeking. In Argentina that kind of spillovers is found in sectors with higher than average effective tariff protection—these sectors would attract “tariff jumping” FDI—, while in Brazil they are found for domestic firms competing with market seeking TNCs affiliates.

• There is no evidence of spillovers on the export activity of national firms as a result of the presence of TNCs, except in Brazil, where spillovers do seem to have occurred, but they were very small in magnitude and were both positive and negative, generally benefiting the most productive local companies and hurting the least productive ones.

• Some studies find that TNCs affiliates that were more integrated within the respective corporations’ global activities had higher innovation expenditures than those that were adapted to operate on the basis of the specificities of the respective host countries. This reinforces the idea that, at present, efficiency seeking FDI may generate better impacts on host economies vis a vis market seeking FDI.

• The available evidence indicates that the effects of FDI in MERCOSUR countries have not necessarily been uniform. Brazil seems to have been the biggest beneficiary, as evidenced by the following findings: (i) key functions for multinational enterprise at the regional level, and, in a handful of cases, at the global level, tend to be concentrated in Brazil; (ii) Brazil accounts for the bulk of the relatively modest inflows of high-tech FDI in MERCOSUR; (iii) the technology content of the exports of TNCs located in Brazil is higher. These trends result from a combination of structural factors (the greater size of the Brazilian economy
and its higher degree of industrial development) and public policy factors (existence of regulatory frameworks that encourage TNCs to engage in R&D activities in Brazil and that attract investment to high-tech sectors).

The automobile industry has traditionally been benefited by State support in many developing countries, and MERCOSUR countries have not been an exception to this rule. Public policies, jointly with a 50 years trajectory of learning in this industry, led MERCOSUR to become a relevant automobile production and sales centre at the world level.

During last years this industry went through a big restructuring process in Argentina and Brazil. Until the 90s, the automobile sector in both countries was heavily oriented towards the domestic market and produced a large number of models at low scales. The changes in the global strategies of TNCs that dominate this sector at world level, jointly with the already mentioned transformation of public policies in the region, fostered a process of specialization and export growth. Not only exports increased, but the number of export markets has been growing steadily, and nowadays MERCOSUR—especially Brazil—exports cars even to markets outside Latin America.

Nonetheless, although the MERCOSUR automobile industry is clearly more competitive than in the past, there is still a long way to reach public policy objectives that usually may justify why this industry receives preferential State support. Those objectives are: i) employment generation, both directly as well—and especially—indirectly (auto-parts, sellers, etc.); ii) the generation of technological or knowledge spillovers; iii) currency savings.

Research undertaken within the MERCOSUR Network shows that: i) In Argentina, Brazil and Uruguay the share of the automobile industry in total manufacturing employment is clearly lower than in past decades due to not only the outsourcing process but also to the reduction of the share of local components in the vehicles produced in the region; ii) Even though this may have had positive consequences in terms of efficiency and quality, it also meant a cost since, at present, the size of the linkages with domestic auto-parts producers is lower than in the past, a fact that reduces the potential generation of technological spillovers; iii) Innovation activities undertaken by automobile TNCs affiliates operating in MERCOSUR are weak (and most of them are concentrated in Brazil), which also reduces the size of spillovers towards the rest of the sector value chain (this is so because knowledge generating activities are undertaken in other...
regions); iv) Regarding currency savings, so far only Brazil has been successful in that objective. On one hand, Brazil has the lower penetration of imported cars within the region (less than 8% of total sales, against 60% in Argentina and almost 100% in Uruguay). On the other hand, while in early 80s Brazil exported nearly the same number of automobiles than Argentina, at present it exports more than 3.6 times than its MERCOSUR partner. Uruguay exports, in turn, are marginal. Similar trends are observed in the auto-parts industry. Hence, the automobile value chain (auto-parts + automobiles) trade balance is in deficit in Argentina and Uruguay, while in Brazil it has surplus since 1999.

Summing up, the results of our research show that it is only in Brazil where the objectives that could justify the State support to this industry have been at least partially met (specially in terms of knowledge spillovers and trade balance). The Brazilian automobile industry has attained significant improvements in its efficiency levels, partly due to the adoption of specialization strategies and to the investments made in the 90s that allowed scale gains and the possibility of competing in extra-regional export markets. The Argentinean industry followed a similar path during recent years, although it has not reached yet the export diversification levels of Brazil. In turn, in the case of Uruguay the most sensible strategy is to support the auto-parts industry with the aim of inserting it within the regional sectoral value chain.

Unfortunately, so far MERCOSUR countries have not been able to establish a common regional policy for this sector. In fact, conflicts and competition for investments have been more usual than cooperative initiatives in order to attain collective efficiency and competitiveness gains for the regional industry as a whole and to materialize the contributions that the development of that industry may generate for the countries of the region.

In this context, the public policy should promote the deepening of specialization and productive complementation strategies, facilitating trade relations within MERCOSUR and with other countries of the region. This implies an attempt to coordinate both the public and private strategies among the countries of the bloc so to avoid the development of local/national competitiveness at the expense of other partners. It is also necessary to stimulate investment in the auto-parts industry in order to take advantage of the growth of the automobile industry because the former might be able to make a larger contribution to the national objectives of employment and knowledge spillovers than the automobile industry. Having the development of the auto-parts sector as a priority is especially valid in the Uruguayan case for growth in the regional automobile industry would guarantee a stable demand in a country where the odds of the automotive industry developing in Uruguay are restricted by the scale and the possibility of holding production agreements with TNCs.
FDI has not been a growth panacea nor a tool for inducing generalized improvements in firms' performance within MERCOSUR countries. However, the available evidence does not support the strongly negative views on the FDI role that have been widely diffused in the region in recent years.

**CONCLUSIONS AND POLICY RECOMMENDATIONS**

Against this backdrop, what should the public policy agenda for the future be? First, it is worth noting that investment flows into the region remain high in comparison with the past. Furthermore, although the process of “de-nationalization” of the leading firms seems to have slowed in recent years, subsidiaries of TNCs continue to carry a lot of weight in the economies of the region. Hence, the public policy agenda must address not only what should be done about the FDI assets existing in the region, but also the strategies to be applied with respect to foreign investors who continue to be attracted by the opportunities that MERCOSUR has to offer.

It should also be noted that, unlike what happened in the 90s—when policies aimed at promoting competitiveness and innovation faded into the background,—in recent years there has been a healthy return to discussion of whether such policies have a place on the agenda of developing countries.

At present, both in international financial institutions as well as in the academic arena, there is more agreement with the need of adopting specific policies aimed at dealing with market and coordination failures that may hinder development processes. Hence, nowadays the challenge is not to find good arguments in favour of those policies based on economic theory and other regions’ experience, but of designing institutional arrangements able to have good diagnostics of the specific problems faced by firms to improve their competitiveness levels in a changing world, adopting policy initiatives in the relevant areas and evaluate their effectiveness.

The foregoing suggests several areas in which policy measures might be applied in order to enhance the direct and indirect impacts of FDI in the countries of MERCOSUR. For example, policies might be aimed at:

- Boosting the capacity and competences of local companies, in particular SMEs, to enable them to take better advantage of the spillover effects from the foreign presence.
- Strengthening incentives for R&D activities, for both TNCs and local companies.
- Initiating negotiations aimed at persuading TNCs to locate more of their corporate strategic activities in their MERCOSUR affiliates and to entrust those affiliates with greater responsibility, for example, with regard to the development of “global products” for worldwide export.
• Encouraging schemes for developing or improving suppliers which could lead to significant vertical spillovers to local companies.

• Promoting various ways of integrating local companies into the value chains led by TNCs, including outsourcing, partnerships and other modalities that have become commonplace in the rest of the world level but whose development remains limited in the MERCOSUR countries.

From the list above it is quite clear that much of the policy action needed to ensure greater spillover effects from FDI flows to MERCOSUR is related to the level of business development in the countries of the region. Certainly, this is a crucial issue that encompasses problems ranging from lack of access to financing—which basically affect capital and technology investment by local companies— to human capital deficiencies, limited absorptive capacity and generation of knowledge, and lags in adopting modern methods of business management.

“Active” policies on FDI are likely to yield better results if the TNCs operating in MERCOSUR are efficiency seekers (but without becoming cheap labour enclaves), rather than seeking only to exploit natural resources or domestic markets, as was largely the case in the 1990s. Accordingly, some thought needs to be given to how to create conditions that will attract a larger proportion of “quality” FDI—i.e., efficiency- and strategic-asset seeking FDI— to MERCOSUR. Such conditions include access to skilled human resources, availability of adequate physical and logistic infrastructure, existence of a good science and technology base, and, of crucial importance, a stable regulatory framework and solid institutions.

Policy development in these areas cannot take place only in the national sphere, however. At the very least, it is essential for the countries involved to coordinate their actions in order to avoid the sort of zero-sum game that results when the existence of certain policies or incentives in one country causes activities or investments simply to be relocated to another country, as a result of which some countries “win” at the expense of others.

Alas, this is easier said than done. For instance, more transparency and the harmonization of investment incentives within MERCOSUR are still relevant objectives in the regional integration agenda. However, in practices, working groups established to analyze those issues have produced almost no outcomes, a fact which illustrates the need of a strong political will to get out of the impasse in this area.

But the bloc should have more ambitious goals, such as the adoption of policies aimed at stimulating complementation and specialization processes at the regional level that could improve competitiveness levels in MERCOSUR as a whole. For instance,
the automobile industry could be the focus of such kind of policies, overcoming what until now has been a basically defensive approach, based on the protection of each country’s market, in order to adopt more offensive strategies based on common and stable regional rules.

In this regard, the reactivation of the regional competitiveness forums (which were launched in MERCOSUR some years ago but never were established) could be a way to begin to seriously deal with the adoption of policy instruments aimed at strengthening value chains at the MERCOSUR level. The active involvement of TNCs affiliates operating in the region in those forums could be a key element for their success.

Other FDI related areas in which there is room for regional cooperation are antitrust - in many markets it is difficult to deal with anticompetitive practices exclusively at the national level- and investment promotion -including the national agencies that are currently functioning in each member country-.

As for the international negotiations agenda, focusing on FDI, at present there is an asymmetric situation within MERCOSUR. This is because some countries have signed a large number of bilateral investment treaties (BITs) -not always on the basis of a careful analysis of their pros and cons, as is it seen in the Argentine case- while others, such as Brazil, have signed none. This leads to the need of adopting of common positions in the face of future negotiations with third parties -such as the European Union or the United States-, given that investment issues will surely be part of the negotiating agenda in those cases. In this regard, it would be wise to take advantage of the fact that currently there is a growing consensus on the need to redefine BITs clauses and structures with the aim of overcoming negative past experiences and in the search of more equilibrium between the interests of host countries and those of the investors.

Finally, it is worth discussing about we have learned so far and on the future research agenda on FDI. After many years of research projects undertaken within the MERCOSUR Network, a sizeable stock of knowledge and evidence has been accumulated on key subjects such as the determinants of FDI attraction, as well on the impacts of FDI on trade, productivity, growth and technology -in both cases, employing methodological tools that have allowed us to prove more rigorously what formerly were intuitions or descriptive evidence results. Within this framework, we have also dealt with the role of public policies in the attraction as well as on the impacts of FDI. We have also analyzed the interactions between regional integration processes and FDI. This stock of knowledge is behind the policy recommendations included in this document.

In conclusion, we want to stress that, according to the empirical evidence, FDI is not, in and of itself, a positive or a negative phenomenon; its impact depends basically on prevailing conditions and policies in the recipient countries. Hence,
policy-making in this area should not be founded on a position that is unconditionally (and ideologically) friendly or hostile to FDI, but rather on the need to build on the results of past experience in order to design instruments and strategies that will maximize the contribution that FDI can make to economic development in MERCOSUR countries while avoiding its possible adverse consequences.
IV. RESEARCHES ON ASYMMETRIES IN THE MERCOSUR NETWORK

Frequently the smaller or less developed countries are not able to capture the benefits of the integration process. This is an important matter because if some members do not expect the integration process to contribute to economic growth, or at least not be an obstacle to it, they find it difficult to gather the necessary political support to consolidate and deepen the integration process. Economic size and wealth are both important factors when it comes to capturing the benefits that stem from the integration process. Theoretical approaches on “geography and trade” emphasize the role of market size because when integration is not deep firms tend to locate in bigger markets. Another dimension that should be taken into account is development level. Poorer regions are usually left behind and are less able to take advantage of the opportunities generated by integration agreements. In the case of MERCOSUR, the poorest and the richest regions are both to be found in the biggest countries.

MERCOSUR is a trade agreement between four countries that are very different not only in the economic dimension but also in development level. Apart from those differences, there are also policy and regulatory asymmetries, such as the fact that there is no macroeconomic policy coordination and the different member countries apply different incentives, and this leads to unfair competition among firms in the region. Many analysts support the idea that these asymmetries are one of the main obstacles to greater integration in MERCOSUR. The smallest partners claim that the asymmetries within the bloc have not been properly taken into account, and this makes for a very unfair distribution of the benefits of the process to the detriment of the smaller economies. In the last few years the question of asymmetries has been on MERCOSUR’s negotiation agenda. However, it is not easy to design policies to fight this problem.

Despite the importance of this question for the region, it has only been studied within the MERCOSUR Network in the last few years. In 2006-2007 four institutions in the network carried out one study, which is the base for this paper.
In economics literature there is a distinction between structural asymmetries and policy or regulatory asymmetries. Structural asymmetries exist when there are big differences between countries in the dimension, in the supply of the factors of production, in development level or poverty and social exclusion levels. Changing these aspects may be a slow process. Policy or regulatory asymmetries consist of differences in public policies and are important in an integration agreement if they affect the competition conditions of its members. Both kinds of asymmetries are important in the case of MERCOSUR. The first kind is important for obvious reasons as this is an integration agreement among countries that are very different from each other. The second kind are also important because efforts to coordinate macroeconomic and competition policies in the region have been weak, and because the different incentive policies in operation tend to overlap even within the countries.

1.1. Structural asymmetries

The countries and regions in MERCOSUR are very different in size and in development levels. Brazil accounts for more than 70% of the surface area of the bloc, it has almost 80% of the total population and produces 73% of the region's GDP (see figures 1 to 4). In contrast, Uruguay and Paraguay have just over 4% of the territory, 5% of the total population and 3.5% of the GDP. There are also big differences when we analyze GDP per capita. Argentina is the country with the highest GDP per capita, followed by Uruguay, Brazil and Paraguay in that order. Therefore even though Uruguay is the smallest country in MERCOSUR it is not among the poorest.

The study of structural asymmetries follows two different approaches. First, it analyzes the problem of growth and convergence among countries and regions within the bloc. Second, it examines the differences in the industrial development of the MERCOSUR countries.

Growth and convergence

To what extent has there been convergence (or divergence) in GDP per capita levels among MERCOSUR regions and countries?

During the period 1985-2004, differences in GDP per capita levels generally widened because Argentina and Uruguay performed more dynamically than Brazil and Paraguay (see figure 5). Regional differences have increased as MERCOSUR integration intensified, but we did not carry out a causality analysis to determine whether the cause of the increase in regional differences is the integration agreement.

There were not absolute convergence in GDP per capita levels in the countries and regions in the MERCOSUR. The convergence process has been governed by some characteristics of the countries and regions within countries, which can be considered as growth-retarding or growth-enhancing factors. The poorer regions, which according to the convergence hypothesis should grow at higher rates thus closing the gap and
approaching the richer regions, are actually growing at lower rates because there are
growth-retarding factors that lead to a lower GDP per capita in the long term equilibrium.
The opposite has happened in the richer regions, where we found that growth-enhancing
factors are in play.

The North and Northeast regions of Brazil, the Northeast of Argentina, and in Paraguay
have grown at lower rates than the rest of MERCOSUR because retarding factors have
operated. In contrast, growth-enhancing factors have been most evident in the
Southeast, South and West Central regions of Brazil, in the rest of Argentina and in
Uruguay.

In Argentina, the inequalities between the richer regions (Greater Buenos Aires,
Patagonia, La Pampa and Cuyo) and the poorer regions (the Northeast and the Northwest)
have become less acute since 1995. In Brazil, the inequalities between the richer regions
(the Southeast, the South and the Center West), and a peripheral regions (the North
and Northwest) have persisted throughout the period.

Measured by GDP, most of the economic activity in MERCOSUR was concentrated in
the Southeast and South regions of Brazil and in Greater Buenos Aires in Argentina.
However, when we consider GDP per capita we find that the biggest regions are not
necessarily the richest. Patagonia, Greater Buenos Aires and La Pampa are the regions
with higher GDP per capita. In contrast, the Southeast and South of Brazil are at an
intermediate level.

The smaller countries are very different from each other. Uruguay is the smallest member,
but in terms of GDP per capita it ranks in the middle of the distribution. Paraguay, on
the other hand, is the most backward country: it is one of the poorest regions in
MERCOSUR and also one of the smallest in size.

To sum up, there are still great inequalities between the different regions within the
bloc, not only in terms of size but also in development level, and that these differences
have persisted over time. The larger regions and those with higher per capita income
(the central regions) have maintained their position and persisted over time, but the
peripheral regions have changed. If the bloc does not design policies to tackle growth­
retarding factors, the current asymmetries will tend to be reduced very slowly, may
remain unchanged or could even worsen.

**Industrial development**

In order to study the evolution of the asymmetries in industrial development in the
member countries, we examined a set of indicators related to protection, trade, and
production in MERCOSUR between 1985 and 2004. The main conclusions are:
Protection. There was a significant fall in tariffs, and indeed, within the bloc, there was greater trade openness for advanced technology products. In the last five years Argentina has actually increased protection within the bloc.

Trade. Intra-MERCOSUR trade flows have increased, especially exports to the other member countries. The share of the region in total exports of advanced technology goods increased from 10% in the period 1985-1990 to 38% in 1995-1998. Imports did not rise as much: the region only gained three percentage points.

Comparative advantages. Brazil has revealed comparative advantages (RCA) over the other MERCOSUR countries in advanced, medium and low technology products. Argentina and Brazil have improved their comparative advantages in numerous industrial sectors including many advanced technology areas, while the smaller countries have developed in low technology and resource-based manufactures. In spite of this, the original export patterns have not changed significantly.

Production. The share of advanced technology sectors in regional production has tended to increase and the share of medium technology and resource-based sectors has tended to decrease. The output share of small countries has decreased in all sectors, except for resource-based sectors in Uruguay, while Brazil's share in all sectors has increased.

Productive specialization. The smaller members became more specialized in the production of manufactures based on natural resources at the expense of other sectors. Brazil, on the other hand, which is the country in the bloc with the most diversified productive apparatus, was the only one to diversify its production. Besides this, its geographic concentration of production intensified, in particular in high technology sectors.

These conclusions were arrived at by Venables (2003), who maintains that a South-South trade agreement promotes industrial development among the bigger and less specialized countries (with intermediate comparative advantages), while the smaller and more specialized countries tend to become more specialized in products for which they have comparative advantages.

To sum up, as a result of a reallocation of economic activities inside MERCOSUR, the smaller members have show a pattern of increasing specialization with a shift towards industrial production structures concentrated in a reduced number of low tech and resource-based sectors. In contrast, Brazil has diversified its industrial production, and the share of advanced tech products has increased.
1.2 Policy asymmetries

In the four MERCOSUR countries there is a long tradition of state intervention to promote production, investment, exports and imports in specific sectors or regions. Despite the policies applied in the 1990s geared to the liberalization of the economy, there are today policy instruments that are a throwback to previous times and these tend to generate inequitable competition among firms located in the different regions or countries, and in different sectors.

In the 1990s, the four countries implemented policies designed to liberalize markets, and they tended to replace vertical or sectoral policy instruments with horizontal policies that benefited all sectors. However, the sectoral policy instruments that were in place did not disappear completely and in some cases they were even reinforced.

In MERCOSUR, the instruments that most hinder the integration process are investment promotion regimes that generate discriminatory incentives for investment location decisions, special import regimes such as temporary admission and draw back, which affect the productive complementary process, and free zones that have an effect on all the objectives of deeper integration.

On the other hand, we did not find any policy instruments that lead to greater integration. The countries designed their productive incentive policies without considering MERCOSUR. In particular, we found that the lack of common competition and macroeconomic coordination policies constitutes a serious impediment to deeper integration.
To what extend did the creation of MERCOSUR contribute to widening or reducing regional disparities? To what extend did MERCOSUR contribute to increasing the specialization and geographic concentration of industrial production? What was its impact on the welfare and growth of the members?

Preferential liberalization has generated a process whereby industrial activities in the MERCOSUR countries have tended to polarize. On the one hand, regional integration has enhanced the comparative advantages of resource-based countries (Paraguay and Uruguay, but also Argentina). On the other hand, the integration process has also promoted the concentration of Brazilian industries that have scale economies, high technological content and that are intensive in skilled labor, even though this country does not have an abundance of skilled workers.

The fact that the MERCOSUR countries are so different in size means that the smaller ones tend to have less influence on key decisions in the integration agreement, and consequently on the distribution of the benefits. The tariffs agreed at Ouro Preto were particularly controversial, especially those applied to capital and computer and telecommunications goods. The smaller countries feel the tariff is too high and that it jeopardizes investment and the incorporation of new technologies, factors which underlie long term growth. These countries requested exceptions and delays in implementation, and this amounts to an obstacle to progress in the integration process. As long as exceptions to the common external tariff (CET) are allowed, MERCOSUR requires a rules of origin regime, and this in turn justifies retaining other policies that give rise to uneven competition between different sub-regions and are therefore an obstacle to the free circulation of goods.

In this study we apply a dynamic general equilibrium model so as to evaluate the effects of three policy scenarios on growth and welfare in the smaller countries in MERCOSUR:

i. To maintain the current situation with exceptions to the CET and with obstacles to free trade within the region;

ii. To quit the CU project and let the smaller members sign agreements with developed markets; and

iii. To improve the CU by adopting the CET approved at Ouro Preto.

Such policies do not radically alter growth or welfare paths. The effects on capital accumulation are relatively small if we compare them with the impact of population growth. In countries with higher population growth, capital becomes scarce so remuneration to capital increases and foreign capital is attracted. Uruguay and Paraguay constitute two extreme cases within MERCOSUR; the former is the country with the lowest population growth rate in the bloc and the latter is the one with highest population growth rate. Lastly, we can expect that in the long term the economic dimension of
Paraguay would increase while the economic dimension of Uruguay would diminish relative to the region. In contrast, given that the capital per worker ratio would fall more in Paraguay, development asymmetries (measured by per capita income) would increase.

Furthermore, trade policies would have only a slight impact on macroeconomic variables. There are two reasons for this: first, because changes in tariffs are not too high since the tariffs currently applied in MERCOSUR are low and they affect less than 50% of consumption and production in these countries as they do not apply to the services sector. In the short term both Uruguay and Paraguay benefited more from policies that intensified the CU. In contrast, in the long term Uruguay can improve its performance by increasing capital accumulation, growth and welfare if it signs free trade agreements with developed countries and improves its access to capital goods at lower prices. For Paraguay, the best option would still be the CU.
The treatment of asymmetries in the EU is usually seen as an example of cohesion- and growth-promoting policies for the less developed countries. We now present this experience, not as a model to be replicated, because the European experience is very different from MERCOSUR, but in order to provide useful tools for a discussion of possible policies for MERCOSUR.

Current EU policies should be traced back to the foundation of the European Economic Community. The policies now in operation were created over the course of several decades as a response to specific problems that arose. These policies have been a source of conflict between national authorities and the community administration, they have constantly been revised, and they have generated a continuous learning process during implementation.

However, two ideological driving forces were crucial to the success of the process: the liberal approach adopted by the European Economic Community from the start, and the fact that cohesion has always been a top priority. This liberal vision has been maintained over the years and it is reflected in the fact that the Treaty of Rome does not include any provisions about industrial policy but does include provisions about state aid regulations, which are dealt with in a special section on competition policies. These policies have turned out to be a key issue in the European integration process. The policies that have been implemented can be grouped into two lines of action, which are to discipline state aid and to promote cohesion.

3.1 Policy asymmetries: state aid control policies

There were serious difficulties in the implementation of state aid control policies, especially in the early decades of the integration process. There was an ongoing confrontation between the Commission, which wanted to put a brake on aid, and the national states, which were providing aid of various kinds. This conflict was more acute in times of economic difficulty when national states were under greater pressure. State aid for specific sectors and other internal policies were a continuous source of worry for the European Commission and a cause of trouble among the member states because they did not want to discipline sectoral support and other internal aid. The most problematic areas were support for sectors with excessive capacity and for activities that governments considered crucial.

From the beginning, the Commission felt that state aid for investment, exports and production distorted the competition conditions for firms located in different countries or regions within the Community. The EU identified state aid as a source of distortion just like anti-competitive practices by private firms. In the early years, the Commission has little influence, but in the long term its vision prevailed. These discipline policies
were seen as a necessary counterpart to policies aimed at reducing structural asymmetries.

Horizontal policies (productive and technological capacity promotion or “horizontal competitiveness” and competition policies) were considered less distorting than vertical (sectoral or regional) policies. The Commission therefore promoted horizontal policies, state aid discipline and trade openness in the field of government purchasing.

State aid was classified into three groups:

i. aid considered to be generally compatible but subject to some restrictions (regional aid, support for small and medium enterprises, environmental protection, research and development, and aid for employment creation and training);

ii. aid generally considered incompatible (aid to promote investment in big firms located outside least-favored regions, export and operational aid); and

iii. aid subject to a detailed evaluation by the Commission (aid for restructuring, rescue, etc).

The first kind of aid is allowed as long as it does not exceed a specific amount (the Commission does not have to be notified about this). The implementation of these policies has been accompanied by continuous efforts to make quantitative evaluations of the costs and benefits of aid.

In 2001, there was a review aimed at reducing the number of aid programs and improving their focalization. There is specific evidence about the elimination of some types of aid, and in most countries government expenditure on these types has been cut back. However, the Commission cannot take all the credit for this because the states have tended to turn to horizontal policies of their own accord in the face of fiscal restrictions that limited their capacity to provide aid.

Progress towards cohesion has been hindered by the fact that most of the state aid is still provided by the more advanced countries. However, there would probably be even greater problems with cohesion if there had been no discipline policy. In the last few years new difficulties have arisen in connection with intervention policies that are less transparent and with the appearance of new instruments not anticipated in the regulations or implemented on the level of local government.

3.2 Structural asymmetries: structural aid and cohesion policies

Since the EU was set up, the member countries, and even more so the regions in the bloc, have been very heterogeneous. For economic and social reasons and also for
political reasons, the EU has implemented a number of policies to tackle these differences. On crucial occasions in the integration process the cohesion policy functioned as a vehicle to promote consensus, and the richer countries made concessions to the poorer ones in order to get their support. The increasing importance of the cohesion policy is reflected in the fact that the EU has increased budget allocations for cohesion funds. In the Treaty of the European Union which came into force in 2003, cohesion was established as one of the Union’s essential objectives.

To tackle asymmetries, a group of funds with well defined objectives and procedures were set up. The main ones were the structural funds and the Cohesion Fund. The structural funds consist of four funds that finance action geared to: (i) the labor market, (ii) agriculture sector support, (iii) financial support for least-favored regions, and (iv) financial support for the fishing sector.

The Cohesion Fund was set up with the objective of reinforcing structural policy in the EU. Funds are allocated to countries with a per capita GDP below 90% of the mean in the bloc. These funds are used to co-finance infrastructure projects (environment and transport). In 2004, new regional development funds were allocated to promote the convergence of the new members in the integration process. There are specific rules for the allocation and evaluation of the resources provided in this way.

Researchers do not agree about the impact of these policies. Some authors maintain that the impact has been slight and that the gaps, as measured by per capita income, have not narrowed. However, there is general agreement that these policies have had a positive effect on the relatively less developed countries that joined the EU in its later stages. In addition, the objectives and instruments of the cohesion policies have tended to move towards EU policy objectives and economic strategy.
In the case of MERCOSUR, it is not easy to design policies to attack this problem because the larger countries are not necessarily the richest, and there are big differences in the development level of sub-regions inside the different countries (Blyde, 2005). Indeed, some of the poorest regions are to be found in the richer countries.

MERCOSUR does not have a long term vision about the treatment of asymmetries. Since the union was set up there have been different visions as to how structural and policy asymmetries should be treated. Before 2003, the question of structural asymmetries almost did not figure on the negotiation agenda, and in cases in which policy asymmetries were considered from the beginning, little has been achieved. In spite of the fact that there are huge differences in relative size and development levels in the bloc, in article 2 of the Treaty of Asunción it is stated that all member countries have the same rights and obligations, and this runs counter to the principle of special and differential treatment. There were no instruments on the negotiation agenda to tackle the problem of these vast differences between different sub-regions in the bloc, and only a few instruments to cater to differences between countries. These consist of adopting extended deadlines, allowing more exceptions in the members' schedules to converge to the Common External Tariff (CET) and to intra-regional free trade, and some sectoral exceptions (the automotive and sugar sectors). Measures designed to benefit the smaller members, namely temporary admission and draw back regimes, were initially maintained but were abandoned when exceptions regimes were extended to all four countries.

Since 2003, the treatment of structural asymmetries in MERCOSUR has been part of the bloc's agenda. One of the most important decisions on this question was the 19/04 Common Market Council (CMC) decision to set up a High Level Group. This group submitted a proposal to set up and regulate a MERCOSUR Structural Convergence Fund (FOCEM). The FOCEM was then set up in 2006 with contributions from the four countries, and in ten years this fund will amount to USD 100 millions. Each country's contributions and benefits are fixed in accordance with its size. Brazil contributes 70% of the funds, Argentina 27%, Uruguay 2% and Paraguay 1%. However, Paraguay is set to receive 48% of the benefits of these resources and Uruguay 32%, and the bigger countries should receive 10% each. The destination of the resources is also regulated: initially the funds must be allocated to the Structural Convergence Program, whose aim is to contribute to development and structural adjustment in the smaller economies and in the least developed regions in the bloc.

In 2003 the CMC adopted a number of decisions that cater to the demands of the smaller partners, accepting new deadlines and exceptions in the process of convergence to a CU. It was also agreed that Paraguay should be treated differently in various respects in negotiations with third markets. It was also accepted that there should be a less demanding rule of origin regime for imports from this country. The decisions also
allow extensions to special regimes for imports (inputs, draw back and temporary admission) and to the schedule for convergence to the CET for computer and telecommunications goods and capital goods. However, only the structural funds are new as regards the treatment of asymmetries, and the other policies only serve to postpone greater integration.

In 2006, the asymmetries question was again on the MERCOSUR agenda. In decision 34/06 there was a proposal for a framework for a plan to deal with asymmetries, and in decision 33/07 a High Level Group was set up to submit a proposal on this subject. In decision 27/07 a more efficient mechanism to eliminate non-tariff barriers to intra-regional trade was established. However, at the time of writing, negotiations seem to be at a standstill.

Paraguay and Uruguay have different interests. Paraguay is demanding compliance with the plan to deal with asymmetries and a widening of the FOCEM, whereas Uruguay wants incentive policies to be disciplined, and also wants the flexibility to negotiate with third markets. So Paraguay has requested measures to tackle structural asymmetries while Uruguay would prefer a plan to reduce regulatory or policy asymmetries. Uruguay has stressed the importance of getting better access to markets and of competition conditions, while Paraguay has promoted special and differential treatment.
In this study we advance some ideas for how MERCOSUR policies to handle asymmetries could be evaluated. Applying a general equilibrium model, we simulate some policy scenarios to estimate their impact. We distinguish two types of policies: those that allow longer deadlines and more exceptions for the smaller members, and those that seek to reallocate financial resources through the FOCEM.

As regards the first group of policies, we compare two scenarios in which we assume a CU without exceptions. In the first scenario the smaller members receive no special or different treatment, and the four countries eliminate all exceptions to intra-regional free trade and to the immediate establishment of a CET. In the second scenario we assume that the smaller members will converge to the customs union in ten years. Our results show that both Uruguay and Paraguay benefit from slow convergence to the CET. The exceptions are an attempt to reduce trade diversion in those products with greater weight in these two countries' imports. Delaying the commitment improves welfare and investment levels because trade diversion decreases and access to big markets improves. However, the gains in terms of welfare and growth are relatively slight, and this policy benefits Paraguay more than Uruguay.

If commitments are delayed but this is not accompanied by other measures geared to reducing adjustment costs or improving competition conditions in the widened market, the impact on asymmetries will be minimal. In addition, these policies have other unwanted results such as maintaining rules of origin and restrictions on free trade within the region, and so they serve to hinder integration.

We then contrast two possible policies as to how the FOCEM should operate. In the first it is assumed that the fund is just a transfer of financial resources between the partners. In the second it is assumed that fund resources are used for investment in infrastructure so as to reduce the two smaller members' regional trade transport costs by 10%. The creation of the FOCEM would have a positive impact on welfare, and this effect is much greater for Paraguay than for Uruguay. However, the fund does not seem to have sufficient resources to be able to effectively tackle the asymmetries that there are. Besides this, the nature of the projects that have been approved and the fact that in practice the fund has only limited resources make it doubtful whether it will be able to enhance regional cohesion. The region also lacks a strategic frame of priorities for the allocation of the funds, and the FOCEM will probably become an instrument for redistributing resources but not lead to greater integration.
Like the EU, MERCOSUR is a region with strong policy and structural asymmetries among the partners. These asymmetries have persisted over time. When measured by GDP per capita, Argentina and Uruguay performed better, but Brazil was successful in promoting industrial growth, diversifying its productive structure and attracting skill-intensive industries. The size of Brazil was an important factor in its ability to take advantage of scale economies in a weak integration process. Policy asymmetries lead to uneven competition conditions between the partners. MERCOSUR has not been able to implement efficient policies to deal with this problem. The partners show different capacities to influence the design of policies.

Also, in the EU, the policies to treat asymmetries have been a source of conflict and they are under constant review and have been changed time and time again. However, two main visions have prevailed over time: the liberal approach of the Commission and the cohesion vision as a top priority objective. State aid was regulated from the very beginning, but there have not been any provisions governing industrial policy. Competition policies have been a crucial aspect of the European integration process. In addition, the various supra-national institutions in the bloc have played an important role in disciplining the interests of the national states.

In the EU, controlling state aid was very important in the treatment of asymmetries. Cohesion policies became important later, because during the early years these policies lacked sufficient resources for implementation. In addition, new commitments on cohesion policies were frequently accompanied by policies to strengthen the integration process, and were used as a mechanism whereby the richer regions compensated the poorer ones.

The treatment of asymmetries in MERCOSUR is as conflictive as in the EU or even more so, but there are no policy or institutional mechanisms to tackle the problem effectively. In the EU, the Commission itself played an important role to promote the common interest. However, in MERCOSUR, the setting up of supra-national institutions does not seem a viable option in the middle or short term. In the light of this limitation, there should be some sort of regional “voice” that reflects interests and visions independent from national interests. But this is not an easy thing to achieve, and the Secretary of MERCOSUR appears too weak to play this role. To make matters worse, there is no strong consensus about what strategic orientation the integration process should follow.

The European experience shows that the treatment of asymmetries is crucial to promoting greater integration. In the EU the treatment of regulatory asymmetries was very important, and in MERCOSUR it seems even more important that these kinds of asymmetries should be tackled and that better conditions of competition should be promote to go again greater integration.
Another crucial issue is that there should be consistency in the treatment of policy and structural asymmetries. The European experience shows that there was coherence in the implementation of cohesion policies and state aid control policies. But in MERCOSUR, on the other hand, structural asymmetries were tackled using instruments (postponing convergence to a CET and free trade within the region) that worked against greater integration.

The treatment of asymmetries should follow a realistic agenda. It is not possible to tackle all the differences that there are so priorities should be set and asymmetries that need to be dealt with at each specific point in time should be identified. The MERCOSUR agenda must focus on asymmetrical policies that have the potential to distort progress towards the objectives of the integration process. But it is not necessary to eliminate those policies completely. The European experience shows that a region can implement common policies, but there are other alternatives such as mutual recognition, progressive convergence and coordination.

Unlike in the EU, MERCOSUR policies have tended to be geared to structural asymmetries. Exceptions for the smaller member countries may have a positive effect on welfare in the region but they are of limited scope and may generate distortions that work against greater integration. The FOCEM is a symbolic rather than a practical instrument, except in the case of Paraguay. It does have a positive impact on welfare in the smaller countries, but in the case of Uruguay the impact is slight. The effect could be much greater in Paraguay because it is a land-locked country. In an integration agreement between countries with low and medium income, which MERCOSUR is, the resources that can be allocated to funds of the FOCEM type are limited. In any case, while the FOCEM may be important as a palliative instrument and as an expression of political will to tackle the problem, we cannot expect it to be the answer to the problem. Therefore, in the future, the bloc will have to focus on how to use these funds efficiently.
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