EUROPEAN UNION FOREIGN DIRECT INVESTMENT FLOWS TO MERCOSUR ECONOMIES: AN ANALYSIS OF THE COUNTRY-OF-ORIGIN DETERMINANTS

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ABSTRACT

The objective of this working paper is to shed light on the macro-level country-of-origin factors that have contributed in the last decade to the upsurge of European Union foreign direct investment (FDI) in the Mercosur countries[1]. The identification of such factors is crucial for Mercosur policy-makers given the role that FDI could play in the macroeconomic evolution of its members.

INTRODUCTION

The increasing flows of foreign direct investment (FDI) over the last decade have placed the analysis of their evolution, effects, and determinants at the forefront of the academic debate. While a substantial amount of research has been conducted in respect of the aforementioned matters, the analysis of the determinants of FDI flows has focused almost exclusively on the characteristics of the host-country. Moreover, where the studies have embarked upon an examination of the country-of-origin factors that influence FDI, they have tended to focus on developed host-countries (Thomas and Grosse, 2001). Such a focus is not surprising when analyzed from a theoretical and an empirical perspective. To be sure, the neoclassical growth model suggests that if capital moves freely across countries, economies where the marginal product of capital is higher should receive net capital inflows. It is generally considered that developing countries display higher returns on capital due to its scarcity. [2] From an empirical perspective, the vast majority of FDI flows from highly developed economies (*See* Table I).

Given the growing proportion of FDI originating in developed nations and flowing to developing countries, I submit that is necessary to complement the analysis of the host-country determinants with that of the country-of-origin of the flows. Such an examination is even more relevant when considering the questions that affect an investment decision such as: (a) whether to invest, (b) when to invest, (c) where to invest, (d) how to invest; and (e) how to finance (Chen, 2000). While the answer to many of these questions may lie in the characteristics of the host-countries, the macro and microeconomic conditions at the country-of-origin, together with the corresponding socio-political dynamic, are probably correlated with the evolution of FDI levels. In this sense, Manzocchi (1999) sustains that the recovery phase of the capital flows cycle to developing countries is related to "push and pull" factors, *i.e.,* global conditions at the "core" and host-region determinants. This document will

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[2] Several authors have shown that the marginal product of capital is not necessarily higher in less developed countries (Manzocchi, 1999).

explore the "push" factors that could influence the flows of European capital to MERCOSUR countries.

The consideration of the EMU as an FDI source further complicates the analysis in several respects. First, while countries such as Spain, Germany and France have invested heavily in MERCOSUR, others, like Austria, Greece, and Finland, do not have strong investment ties with the MERCOSUR region. Moreover, despite the relatively high degree of economic convergence observed among the European countries that formed the Single Market,[3] there are still enormous economic and socio-cultural differences within the EU that affect company behavior. These differences affect the global strategies of firms, thereby influencing the geographical and sectoral destination of FDI. Secondly, it is extremely complicated to isolate the impact that different region-of-origin variables —the euro, the greater context of European integration and technological advances— could have on the Euroland FDI flows to MERCOSUR countries. Finally, the process of European enlargement is also a challenge confronted by the researcher due to the uncertainty generated by the unclear timetable of accession, the enormous structural economic differences among the ten Central and Eastern European countries that are candidates for membership (CEE-10) and to the complexity of the analysis of the potential future deviation of FDI flows to the CEE-10.

Bearing in mind these limitations, the analysis proposed herein considers several country-of-origin factors that affect the evolution of EU FDI flows to MERCOSUR countries. The selection of these factors is based on the extrapolation of the literature on country-of-origin analysis to the specific case of the European FDI in MERCOSUR and on the statistical analysis of the relevance of such factors.

The elements that will be considered can be classified in economic and historical-political categories. Within the first group, the economic factors are as follows:

(A) Market size and demographic characteristics of the region-of-origin;

(B) The impact that the euro and other developments of the process of European Monetary integration (EMU) could have on the financial markets, specifically the effects on the cost of borrowing, the evolution of the exchange rate and the evolution of the investment-savings balance. These variables are considered by the literature reviewed as determinants of FDI flows; and

(C) The effects of the accession of the CEE-10 to the EU.

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[3] Martín, Velásquez, and Funck (2001) empirically demonstrate that the EU level of income per capita has been converging towards that of the United States. These authors also show how the lower income countries of the EU have been displaying levels of income per capita that converge towards the EU average.

The analysis of the second group of determinants, the historical-political variables, will take into account the existence of profound historical and cultural links between both regions, and will also examine the relevance of the existence of political alliances.

REGION-OF-ORIGIN ECONOMIC DETERMINANTS

While little research has been conducted on the characteristics of the region/country-of-origin of FDI flows to emerging markets, there is a vast amount of literature on fields such as the theory of the firm, the theory of international trade (extension of the Heckscher-Ohlin model to include capital mobility), and country-level macroeconomic analysis, which enable the construction of a theoretical framework suitable to examine the following elements.

MARKET SIZE AND DEMOGRAPHIC CHARACTERISTICS

Market Size

FDI outflows have traditionally had high-income countries as their source. Table I displays how this trend has continued during the 1990s, and, what is more relevant to this analysis, how the EU has played a crucial role as a direct investor. The flows originating in the EU amounted to approximately half of the total flows sourced in the high-income countries. That fraction has steadily increased and in the year 2000, the EU FDI flows represented 73 percent of all FDI originating in the developed world.

TABLE I. DISTRIBUTION OF FDI OUTFLOWS, 1989-2000

(BILLIONS OF US DOLLARS)

	1989-1994 ANNUAL AVERAGE	1995	1996	1997	1998	1999	2000
DEVELOPED COUNTRIES	203.2	305.8	332.9	396.9	672	945.7	1046.3
EUROPEAN UNION	105.2	159	183.2	220.4	454.3	720.1	772.9
UNITED STATES	49	92.1	84.4	95.8	131	142.6	139.3

Source: UNCTAD, 2001.

The empirical literature corroborates the importance of market size as a country-of-origin determinant of FDI flows. For example, Grosse and Trevino (1996) demonstrate that the larger the home-country market, the greater the FDI into the

United States. While their conclusions for the specific case of the United States cannot be directly extrapolated to developing countries, such as those that comprise the MERCOSUR, other empirical analyses that focus on middle-income countries have reached the same conclusion regarding the importance of the role played by country-of-origin market size as a determinant of FDI flows. In this sense, Thomas and Grosse (2001) find that there is a positive correlation between home-market size and FDI flows to Mexico.[4]

Adopting now a dynamic perspective, Graph I shows the correlation of the economic cycles of the EU, the MERCOSUR countries and the OECD countries. There are three features that stand out from this graph. First, the EU real GDP growth rate follows the same pattern observed in the rest of the developed world during the 1990s, but substantially differs from the one displayed by MERCOSUR. Secondly, the EU growth represents a large percentage of the growth of the total OECD countries. Finally, the MERCOSUR business cycle is highly volatile.

GRAPH I. EU, OECD and MERCOSUR ECONOMIC CYCLES
1991-2000
(Percentage change of real GDP from previous period)
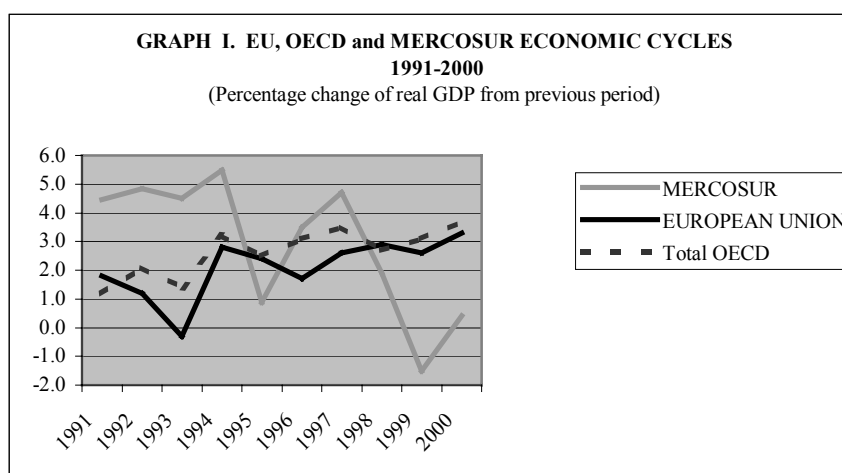
Source: Author's elaboration of data from OECD, 2001 and ECLAC Macroeconomic Database.

These initial observations confirm that the EU, one of the largest sources of direct investment, is also one of the largest economic regions of the world and its GDP growth rate explains a significant component of the economic growth in the developed world. With regard to MERCOSUR, while the volatility of its business cycle could be a deterrent for EU FDI flows, its low correlation with its EU counterpart is advantageous in terms of diversification of investment. This is especially relevant for the financial sector, one of the protagonists of the surge of FDI flows to Argentina and Brazil, since it can take advantage of the returns on financial instruments issued in different countries that could have relatively low or even negative correlations (Berger, De Young and Udell, 2001).

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[4] According to World Bank's country classification, Mexico is an upper-middle-income country. All of the MERCOSUR countries, with the exception of Paraguay, belong to the same category.

While the economic developments in the EU greatly depend on the situation of the global economy, the influence of the EMU on economic growth has received significant attention. The report "One Market, One Money: An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union" (European Commission, 1990) set the stage for a series of optimistic analyses of the prospects for economic growth driven by European integration. This report highlighted the positive impact of EMU through the efficiency gains expected from the elimination of transaction costs[5] and through the stability effects and the higher rates of investment growth induced by the lower risk premia[6] and the stricter monetary and fiscal discipline.

From an empirical perspective, the simulations carried out by the International Monetary Fund (IMF, 1997) consider two scenarios. In the first, the EU advances in the process of fiscal and structural adjustment. The results in levels of output amount to almost 3 percent by the year 2010 for the EMU members, while only 0.1 percent and 0.2 percent for Non-European members of the G-7 and other industrial countries, respectively. In the second scenario, the member countries do not implement the necessary reforms, thereby causing a decrease in output by 2.5 percent.

According to Cohen (in Wyplosz, 2001), given the recent European developments there is no reason to believe that the first scenario is more probable than the second. In this sense, assuming that the rate of economic growth for the EU members falls somewhat in the middle of the two scenarios, the likelihood of a significant direct impact on FDI flows to MERCOSUR is nominal, although it will depend on the dynamics of the trade channel, as well as the evolution of the potential host economies and their competitors for FDI.

Another factor that appears to corroborate the aforementioned conclusions is the characteristics of the multinational corporations (MNCs). The patterns observed in MNCs are relevant to this analysis since they contribute to around 70 percent of the world's FDI flows. According to UNCTAD (2000), the world's 100 largest MNCs (ranked by foreign assets) have a high-income country as country-of-origin. From a theoretical perspective, the characteristics identified by the economic literature as typical of an MNC correspond to patterns that are difficult to encounter outside the developed world.

James Markusen (1995 and 1998) identifies the following as the characteristics of the economic sectors where MNCs tend to have an important presence: a) significant levels of investment in research and development;[7] b) large number of

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[5] The transaction costs associated with the existence of national currencies was estimated to amount to approximately 0.5 percent of GDP in the mid-1980s (European Commission, 1990).

[6] A decrease in risk premia of 0.5 percent could promote an increase in EU GDP between 5 percent and 10 percent (Baldwin, cited in Bekx, 1998).

[7] The role played by research and development in MNCs investment activities is also highlighted by Vernon (cited in Miller and Weigel, 1972).

professional, scientific and technical workers; c) use of complex technological production processes; d) high levels of product differentiation and advertising, and e) high ratio of intangible firm-specific assets,[8] such as trademarks, patents, know-how, management, and marketing skills. All of the aforementioned characteristics are more likely to be found in high-income developed countries, again, the main suppliers of FDI flows. From a dynamic perspective, Caves (1996) states that the literature of economic history demonstrates that periods of rapid domestic economic growth have encouraged the expansion of the international activities of MNCs. In summary, both the size of the market and its evolution influence the activities of MNCs and therefore impact FDI flows.

One final element that links market size with FDI flows is what the OECD (1995) refers to as the "post-fordist" model of industrial organization. This system, which has received little attention by mainstream economic analysis, is characterized by two main features: (a) the importance attributed to the physical proximity between firms and both suppliers and customers,[9] and (b) the decrease in the share of labor costs in total operating costs vis-à-vis a rapid increase in the share of marketing and R&D costs. It is noteworthy that the second pattern coincides with one of Markusen's characterizations of the economic sectors in which MNCs are likely to operate. What is relevant for this analysis is the fact that the requirements identified by the OECD (1995) and indirectly by the UNCTAD (1998) as necessary for this new industrial organization to take place are likely to be found in highly developed countries. To be sure, these requisites are: (a) existence of a highly skilled labor force, and (b) modern communications and transportation infrastructure.

In conclusion, from both static and a dynamic approach, market size and the characteristics inherent to this variable play a significant role as determinants of EU FDI flows. The EU is one of the largest economies of the world and, despite the different propensities to invest abroad displayed by the member countries, the region as a whole is the larger global foreign investor and one of the main sources of capital for the MERCOSUR countries. While an analysis of the correlation between country-of-origin market size vis-à-vis host-country market size could complement the examination of the determinants of FDI flows, it is outside the scope of this investigation.

Demographic Characteristics

The results of the UN population prognosis displayed in Graph II show a grim demographic future in Europe that is already posing an enormous challenge to

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[8] Intangible firm-specific assets is one of the elements that form what John H. Dunning (1977) labeled as "ownership advantages," identified as one of the three necessary conditions —"location advantage" and "internalization advantage" — are the other two for a firm to invest abroad. This is usually referred to as the OLI framework.

[9] The importance of the proximity between firms has been highlighted by Shatz and Venables (2000) as a determinant of FDI location. By the same token, Dunning (in Dunning and Hamdani, 1997) argues that there is an increasing desire by firms to establish close relationships with other firms.

European politicians. This challenge is not caused by the prospect of a decline in population, but rather by the shift in the age structure that is resulting in an increase in the share of senior citizens in the population.

GRAPH II. EU-15, CEE-10, and MERCOSUR:
Average Annual Population Growth, 1999-2015 (%)
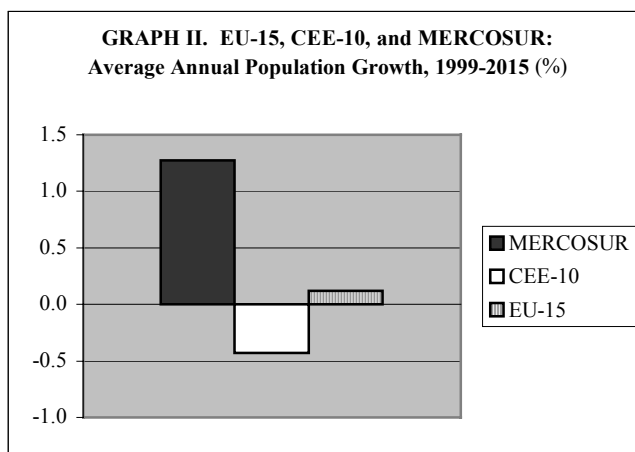
Source: Author's elaboration of data from UNDP, 2001

The economic effects of population growth are supposed to be alternatively negative, positive, or non-problematic depending on the theoretical perspective. In the neoclassical models of economic growth, a decrease in population growth results in an increase in the capital-labor ratio that leads to higher rates of per capita income growth. [10]   However, once the impact of population aging is taken into account, the macroeconomic effects are not that clear. According to Boersch-Suppan and Winter (2001), while in the medium and long-term, households incentives to save in aging countries could be reduced by the relative abundance of capital, in the short term, these authors' simulations for European countries show that savings rate will reflect an increasing trend until approximately 2020.

Focusing now on the main topic of this investigation, the increase in the savings rate could encourage capital exports from fast-aging regions, such as the EU, to countries with a younger age structure (Boersch-Suppan and Winter, 2001). Lin and Szenberg (in J. H. Dunning, 1998) identify the saving surplus as one of the main macroeconomic determinants of Taiwanese flows of FDI, although in the Taiwanese case, the aging of the population is not the principal propeller of such accumulation of savings. Bosworth (1996) contends that the combination of a slowing population change and the lengthening of life expectancy—both present in Europe—should encourage an increase in saving rates during the working years. Up until recently, the macroeconomics effects of such increase have been offset by the high public sector deficits that have traditionally characterized the European economies.

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[10] For an analysis of the impact of demographic variables on net international capital flows under the assumptions of both the neoclassical model of growth and models of endogenous growth, *see* S. Manzocchi (1999: Chapter 3).

However, the strict monetary and fiscal policies that have been adopted by the EU and especially by Euroland countries, are likely to create healthy public sector balances, freeing therefore private savings that could be allocated to both domestic and foreign investment.

It is difficult to quantify the impact of the short-term increase of savings rate on capital flows and to predict what share of those capital flows would be in the form of FDI. However, the results from Graph II and the aging of the European population suggest that neither the EU-15 nor the CEE-10[11] is attractive for FDI flows that are trying to *escape* the aging of the population. In this sense, MERCOSUR presents itself as a much more attractive region, not only in terms of a relatively higher population growth rate, but also when taking into account the young structure of the population as displayed by Graph III.

Graph III. Population under age 15, 1999
(% of total)
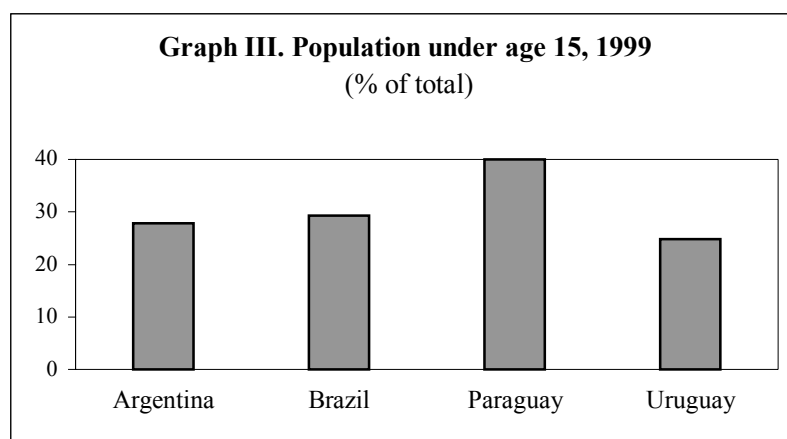
Source: Author's elaboration of data from UNDP, 2001.

The young MERCOSUR demographic structure is relevant, especially when considered relative to the older demographic structure that characterizes the European continent, for the attractiveness of the financial sector as a recipient of FDI flows. To be sure, considerations of the future access to financial services, as well as the potential increase in savings encouraged by the accumulation of capital by intermediate generations, as predicted by Modigliani's hypothesis of the life cycle, make the MERCOSUR's financial sector an appealing host of EU FDI flows.

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[11] For an explanation on the surprisingly low average rate of annual population growth on the CEE-10 countries, *see* "Fertility decline in the transition economies, 1989-1998: Economic and social factors revisited" included in the Economic Survey of Europe 2000, No. 1.

THE EURO AND EUROPEAN MONETARY INTEGRATION

The introduction of the euro constitutes one of the most significant economic and political events of the twentieth century. The EMU is not only a historic achievement in the process of European integration, but also a dramatic turnaround in Euroland's economic policies. Given the weight that the EU has in the international economy in terms of GDP, volume of trade, and level of international financial transactions, it is expected that the adoption of the euro will have a vast impact beyond European borders.

The vast majority of the literature reviewed for this document focuses on the general effects of the euro on the international monetary system and the influence of the new currency and the policies associated with its introduction over the economic evolution of the CEE-10. Analyses of the current and potential effects on developing countries are scarce, in particular for the Latin American region. The framework proposed herein seeks to isolate certain impacts of the introduction of the euro that could influence Euroland FDI flows to MERCOSUR countries from a static perspective. To be sure, the host-country characteristics will remain ceteris paribus, although some spillovers of the creation of the euro could, in the long term, induce small changes in the host-country features of MERCOSUR countries.

Among the variables related to the adoption of the new European currency, the focus will be on those that are more likely to exert direct economic influence on the flows of FDI to MERCOSUR countries. In general terms, the elements related to the impact of the euro can be classified between trade and financial variables. The literature on the impact of the euro on Latin America suggests that the trade link is important for the region as a whole, while acknowledging that this link is weakened by the nominal degree of trade openness that characterizes the region (Levy Yeyati and Sturzenegger, 2000a; Verner, 2000, and Miotti, Plihon, and Quenan, 2001). Given the increasing share of both MERCOSUR imports and exports in the European market, this investigation will take a closer look at this link in the context of the Framework Cooperation Agreement between the EU and MERCOSUR.

In addition to the trade and financial links, some researchers also point to the impact in terms of economic growth in the European region encouraged by the adoption of the euro and the developments associated with its introduction (Bekx, 1998; Verner, 2000; and Bauman and Abreu in Da Motta Veiga, 2000). However, such real effect is difficult to isolate from the evolution of the global economy. Moreover, the influence that higher economic growth could have on FDI flows to MERCOSUR could be somewhat offset by the increasing attractiveness of a more integrated Euroland and by investment opportunities in CEE-10 countries. As stated above, such flows would also depend on the macroeconomic and political conditions displayed by the MERCOSUR countries and on the status quo of the MERCOSUR process itself.

Turning now to the financial impact of the introduction of the euro, the variables that will be analyzed are the effects on the cost of borrowing, the evolution of the exchange rate and the evolution of the investment-savings balance.

a) Cost of borrowing

When a company decides to invest abroad, the financing of the investment operation can take three forms: through retained earnings, public offering of securities and accessing the credit market. In this sense, the particular conditions of each of the three alternatives are likely to influence the decision to invest abroad, the amount transferred and even the location of the investment. For the specific case of MNCs, decisions regarding financing appear to be interdependent with those of global investment and highly responsive to macro and microeconomic constraints (Caves, 1996).

From an empirical perspective, Grosse and Trevino (1996) find that there is a negative correlation between the cost of borrowing in the country of origin and investment in the United States¾ measured by the country-of-origin prime rate relative to the United States prime rate. When testing the same hypothesis for the specific case of a developing country (Mexico), Thomas and Grosse (2001) demonstrate the existence of the same negative correlation. According to these scholars, the explanation is simple: "Lower cost of borrowing in the home country provides a cost advantage to firms when investing in other nations where the cost of borrowing is higher" (Thomas and Grosse, 2001:65).

Klein, Peek, and Rosengren (2000) identify the collapse of the Japanese banking sector and the consequent difficulties in accessing credit as one of the principal explanations for the sharp decrease in Japanese FDI flows into the United States. In the countries of the EU, bank lending has traditionally been a dominant source of company financing although this pattern began to erode in the mid-1990s and, it is increasingly being replaced by the issuing of debt securities (Danthine, Giavazzi and Thadden, 2000; Verner, 2000 and Brookes, 1999).

Graph IV displays the lending rates¾selected as a proxy for the cost of borrowing from the banking system¾ of those European countries that have been the source of FDI flows to MERCOSUR countries during the 1990s. The graph clearly demonstrates the decreasing tendency experienced by the lending rates, from an average of 14.36 in 1990 to 5.53 in 1999.

Graph IV. Lending Rates in Selected European Countries
(Period average in % per annum)
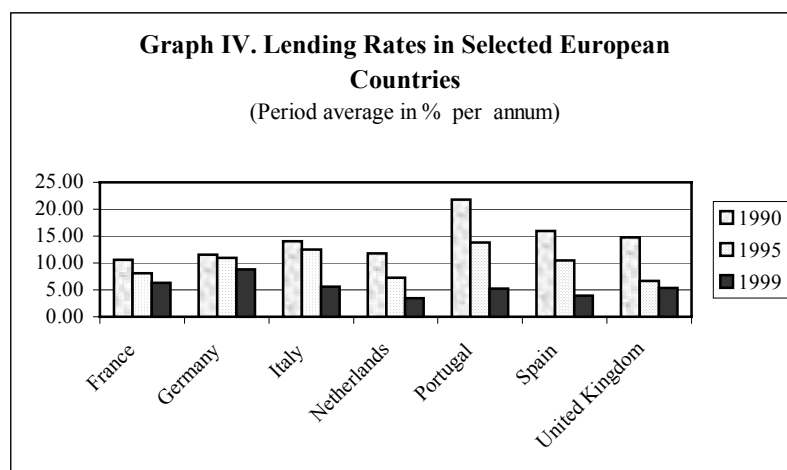
Source: Author's elaboration of data from IMF, 2000

While it is clear that the EMU and the subsequent regulatory changes have led to the convergence of interest rates across Europe and to a reduction in official interest rates, the process of globalization of financial markets had already increased competition within the banking sector before the forces of monetary integration were in place. A comprehensive series of the lending rates for the MERCOSUR countries is not available, but given the relatively low degree of financial competition present in the region, the absence of coordination in economic policies, and the higher interest rates, it is expected that the EU countries show lower and more stable lending rates. In this sense, the cost of borrowing would be lower in the EU than in MERCOSUR and could therefore, incite flows of direct investment to the region. However, given the aforementioned tendency of European companies to replace bank financing with security financing , the relatively lower cost of borrowing through the banking system should only have a minimal impact on EU FDI flows.

There are other aspects of the cost of borrowing that are likely to exert more influence on FDI flows. Reisen (2000) states that changes in the relative capital costs for companies based in industrial countries, especially the European stock market boom that reduced equity costs while emerging markets were experiencing an increase in the capital costs due to the rising sovereign risk spreads, could partially explain the rise in M&As in Latin America. For the case of the EU, the euro and the process of economic integration in general, have created more liquid financial markets that have lowered the costs of borrowing by reducing financial transaction costs and risks. At the same time, the ongoing process of financial integration and corporate restructuring is expected to accelerate the trend of rationalization and increased competition already in place in European financial markets (Levy Yeyati and Sturzenegger, 2000a). This trend could be reflected in a rapid development of euro-denominated stock markets and has been evident in the dynamism of the euro-bond market since its introduction.

This trend has affected both the equity and debt markets in Euroland. With respect to the former, most of the European equity markets have traditionally been characterized by low degrees of market capitalization. The introduction of the single currency, the process of corporate restructuration and the high levels of issuance activity of the telecommunications companies have changed this framework, encouraging the increase in both the demand for and the supply of equities (Danthine et al, 2000; Thiel, 2001, and Flowers and Lees, 2002). The number of domestic companies listed on the euro area stock exchange increased to 4,900 at the end of 2000 from 3,900 only two years before and the amount of new capital raised on Euroland stock markets increased almost 150% for the same period (European Central Bank, 2002: February). Graph V a displays the evolution of the market capitalization for both Euroland and the United States and reflects the rapid development of euro-denominated stock markets although still lagging behind its US counterpart.

Graph Va. Market Capitalization of Domestic Shares (% of GDP)

Graph Vb. Market Capitalization of Listed Companies (% of GDP)
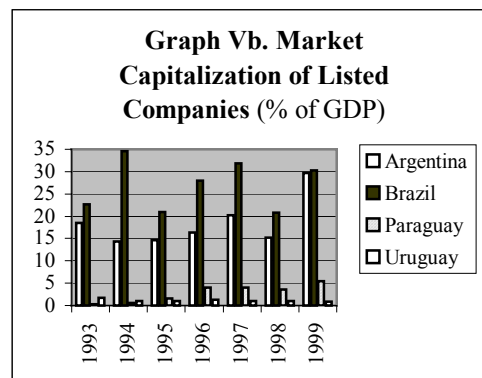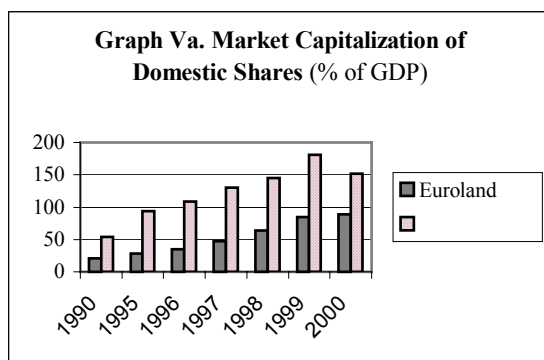
Source: European Central Bank, 2002: February.   Source: World Bank WDI.Database, 2000.

This evolution signals a boost in the availability of capital in the Eurozone that could increase the outflows of direct investment in two ways: through greater disponibility of resources to finance investment in external markets and via the impact that the enlargement of equity markets may have on competitiveness among rival companies potentially encouraging them to extend operations to foreign markets. However, when analyzed from a comparative perspective, it reflects the interaction between "pull" and "push" factors that determine the volume and the distribution of FDI flows. In this sense, the European companies could take advantage of this competitive advantage by borrowing at home to finance direct investment operations in MERCOSUR.

The evolution of Euroland bond markets is relatively similar to that of the equity markets. Before the mid-1990s, bonds played only a nominal role as a source of private corporate financing within Europe leaving the market for the "preserve of the public sector and of high quality financial institutions" (Perée and Steinherr, 2001:10). This situation changed after the introduction of the single currency as illustrated by the fact that during the first nine months of 1999, non-financial corporate bond issues increased by close to 300 percent over the same period in 1998. The boom in the issue of bonds, especially in the private sector, is considered as the most important effect of the adoption of the euro (Miotti et al, 2001).   As Table II shows, there has been a remarkable increase in the share of the outstanding bonds of corporations, while the fraction controlled by banks has been reduced. The comparison with the data for the United States clearly indicates that, despite the increased activity in the corporate bond market, Euroland's markets still lack the dynamism of its US counterpart.

TABLE II. DISTRIBUTION OF OUTSTANDING NON-GOVERNMENT BOND MARKETS

(% OF TOTAL)

	UNITED STATES		EUROLAND	
	1995	2000	1995	2000
CORPORATIONS	28.5	24.8	8.1	16.3
FINANCIAL INSTITUTIONS	18.9	20.8	56.3	49.2
COLLATERALIZED DEBT	39.6	39.2	19.5	26.1
NON-GOVERNMENT PUBLIC SECTOR	11.5	13.7	11.6	5.3
SUPRANATIONALS	1.6	1.5	4.4	3.1

Source: Perée and Steinherr, 2001: 11 on data from BIS, 2001.

Table II also reflects the increasing tendency toward the Anglo-Saxon model of direct financing by European countries that have traditionally relied on bank credit financing. As already suggested, there is no significant evidence that this potential change from bank-based to market-based financial system affects industrial growth. However, the developments taking place in the corporate bond market may increase the depth of the Eurozone financial markets, thereby positively affecting both credit availability and cost of borrowing (Beck and Levine, 2000).

These developments could have two poignant effects on EU FDI flows to emerging economies, such as those of MERCOSUR. On one hand, following the presented theoretical framework and empirical evidence, the expected decrease in the EU cost of borrowing could lead to what Dunning (in Ohlin, Hesselborn and Wijkman, 1977) framed as "location advantage," identified as one of the three necessary conditions for a firm to invest abroad. Although Dunning did not explicitly include the relative cost of capital as a location advantage, the importance of the financing aspects of MNCs' investment operations suggest that borrowing conditions could play a significant role in investment decisions.

On the other hand, the reduced scope for diversification due to the convergence of bond yields and the increasing correlation between equity prices within the EMU borders (Verner, 2000; Perée and Steinherr, 2001 and Brookes, 1999) could make the MERCOSUR economies more attractive as hosts of both portfolio and direct investment. This is especially relevant for the banking sector which, subject to the process of deregulation and increased competition encouraged by the Second

Banking Coordination Directive implemented in 1993 and 1994, has followed the domestic companies abroad in an effort to adapt to the new environment created by the euro, the aging of the European population, and global financial developments. The internationalization strategy, the most significant example of which is the establishment of Spanish banks in Argentina, also responds to the "oligopolistic reaction paradigm" that predicts that the competition among domestic rivals would be transferred to foreign markets (Hernansanz and Sebastián, 2000).

In summary, although the cost of borrowing is a variable that has received scarce attention by the traditional literature of determinants of FDI flows and the theory of the international firm, its impact on European FDI flows to emerging economies could be significant. The relatively low cost of borrowing through the European banking system is not expected to exert a large influence on FDI outflows given the tendency of "americanization" displayed by the entire European financial system, particularly by that of Euroland. However, the elements associated with the introduction of the euro¾such as the elimination of exchange rate risk, the reduction of financial transaction costs, and the increase in competition¾together with the evolution of the global financial system, are already displaying symptoms of the advent of a deep and liquid capital market within Euroland. These developments, which clearly indicate higher overall levels of financial development in the Eurozone, could be translated into increasing EU FDI flows to MERCOSUR through a relatively low cost of borrowing and larger credit availability in the region-of-origin, faster growth of firms that use external financing, and the desire of diversification given the potential convergence of European rate of returns.

b) Evolution of the Exchange Rate

After the 1978-1981 and 1986 surges on foreign investment into the United States that coincided with periods of dollar weakness, the economic literature began to explore the possibility of a link between exchange rate movements and FDI. The existence of such potential link affects the analysis proposed in this thesis because the introduction of the euro in January 1999 has engendered a significant change in the international monetary system.

The results of the reviewed literature exploring the exchange rate as a determinant of FDI do not generate consensus. Froot and Stein (1991) and Froot (1993) consider that there is a link between wealth positions and FDI flows. Taking such a link into account, a currency depreciation in the host-country increases the relative wealth position of foreign investors by lowering the relative cost of capital, thereby encouraging FDI and influencing its timing. Extrapolating this analysis to the country-of-origin, it follows that an appreciation of the country-of-origin currency could lead producers to shift locations and invest abroad. Using Dunning's OLI framework (1977), movements on the exchange rate can promote a "location advantage." Grosse and Trevino (1996) empirically demonstrate that the greater the appreciation of the home-country exchange rate against the US dollar, the greater the FDI into the United States. Moreover, the results of their analysis indicate that the exchange rate is as significant as other traditional FDI explanatory variables, such as bilateral trade levels and home-country GDP. Similar results have been obtained by Klein and Rosengren (1994), Goldberg and Klein (1997) and Chen (2000).

Considering Mexico as the host-country, Thomas and Grosse (2001) demonstrate that there is a positive relationship between the appreciation of the currency of the country-of-origin relative to the Mexican peso and flows of FDI to the country.

On the other hand, there are analyses that do not confirm the existence of a link between exchange rate movements and FDI flows. In this sense, Healy (in Caves, 1996) finds that changes in real exchange rates between the source and the host country are not determinants of international equity investments for eleven industrial countries during the period 1985 to 1990. Using data on foreign acquisitions of US firms between 1975 and 1989, Dewenter (1995) examines the relationship between the dollar exchange rate and cross-border acquisitions. After controlling for the overall level of investment and differences in relative corporate wealth levels, Dewenter demonstrated that there is no statistically significant link between the level of the exchange rate and FDI relative to domestic investment.

There are two elements that complicate the extrapolation of the analyses described above to the subject of this investigation. On one hand, the MERCOSUR countries do not have a common currency. Moreover, the MERCOSUR block lacks monetary, financial and fiscal coordination. These absences together with the asymmetry of income levels, the nonexistence of labor market integration (Levy Yeyati and Sturzenegger, 2000b) and the current economic crisis in Argentina, jeopardize a potential Optimal Currency Area in Mundell's terms. While this characteristic complicates the analysis of the evolution of the euro vis-à-vis the MERCOSUR exchange rates, it is noteworthy that the trade and financial relations of the block are usually valued in US dollars. In this sense, the examination of the exchange rate of the euro against the US dollar can be used as a proxy. On the other hand, the young age of the euro¾introduced only three years ago¾makes it difficult to explore long-term perspectives.

The decline in the value of the euro since its introduction in 1999 has been a source of concern for European policy makers. This decrease is especially relevant when taking into account the euro-dollar rate (Graph VI). The movement of the transatlantic exchange rate reflects both the weakness of the European currency and the strength of the dollar against other currencies.

**Graph VI Bilateral Euro and ECU
Exchange Rate against the US Dollar**
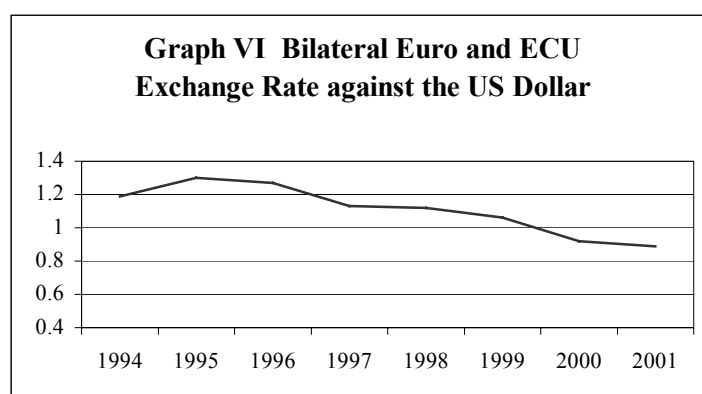
Source: Author's elaboration of data from the European Central Bank, various years. Until 1998, exchange rates are for the Ecu, since 1999 rates are for the Euro.

According to the literature that supports the existence of a link between the exchange rate and FDI flows, the evolution of the Euro exchange rate against the US dollar should have an impact on FDI flows from Euroland to the United States and to other regions where asset prices are expressed in dollars such as in the MERCOSUR countries. Table III displays the growth of European FDI flows to MERCOSUR countries between 1994 and 1999. The years 1998 and 1999 show a dramatic increase in the European investment in Argentina and Brazil. During those two years, Argentina maintained its semi-orthodox currency board while Brazil abandoned the crawling peg to the dollar in 1999 and decided to adopt an independently floating system (as classified by the International Monetary Fund), thereby encouraging a dramatic devaluation. At the same time, the euro was being introduced in Europe with the expectation that it would sustain its value in dollar terms or that it would even appreciate against the US currency.

TABLE III. EUROPEAN FDI OUTFLOWS TO MERCOSUR (EQUITY AND OTHER CAPITAL)

1994-1999

(MILLIONS OF ECUS/EUROS)

	1994	1995	1996	1997	1998	1999
ARGENTINA	494	817	1405	2046	3369	17077
BRAZIL	281	798	2592	4270	17742	10968
MERCOSUR	838	1653	3981	6375	21178	28127

Source: European Commission, Eurostat, 2001.

Given the short period of analysis, it is difficult to examine the extent to which the expectation of an appreciated euro could have influenced the European foreign investment decisions. Moreover, a large percentage of the increase in flows observed in 1999 corresponds to "Operación Verónica" carried out by Telefónica de España in its own subsidiaries in Argentina, Brazil, and Peru in order to increase its control of those companies (ECLAC, 2001). While it is possible that exchange rate expectations are one of the elements that could have affected the timing and/or the amount of the operation, it is also true that factors such as the liberalization of the telecommunications sector in Brazil and the need to defend strategic positions in Argentina may have had more influence in certain large FDI operations than the introduction of the euro and the expectations evolving around its creation.

The potential volatility of the exchange rate of the euro together with the potential effects of such volatility on FDI flows is increasingly receiving attention. Cohen (in Wyplosz, 2001) and Begg, Giavazzi, and Wyplosz (1997) argue that such

volatility will increase for two reasons. On one hand, in the event of domestic or external shocks, the European Central Bank cannot use the internal exchange rate to smooth out fluctuations. This restriction can encourage a transfer of variability from the Euroland exchange rate to that of the euro vis-à-vis other currencies, for example through interest rate variations. On the other hand, the main objective of Euroland monetary policy is the achievement of price stability. External goals, such as exchange rate stability, could therefore fall in a second place encouraging "benign neglect" vis-à-vis the dollar, i.e., EMU will not impact US policies while European policy makers pay less attention to the bilateral exchange rate unless a large misalignment has a profound impact on competitiveness (Begg, Giavazzi, and Wyplosz, 1997 and Kenen, 1995).

There are, however, analysts that have predicted that the introduction of the euro will bring more stability to the transatlantic exchange rate. In this sense, Bénassy-Quéré and Mojon (1998) examine the potential effect of EMU on transatlantic exchange rate variability through a three-country simulation model for the US, Germany and France. They find that the monetary union stabilizes the European exchange rate vis-à-vis that of the dollar. In the same vein, Martin (1998) analyzes the introduction of the euro from the perspective of a change in the relative size of the participants in the international monetary system. By using a simple two-country model with random supply shocks, Martin argues that the introduction of the euro implies the creation of a monetary block comparable in size to the US and therefore, a more symmetric system that will lead to a less volatile transatlantic exchange rate.

Mundell (1995) considers two different scenarios with regard to the stability of the exchange rate of the euro. The unattractive scenario is one in which both the EMU and the US strive to build their own currency areas encouraging transatlantic exchange rate instability. Under this scenario, the Latin American economies would be in the dollar area and Euroland FDI on MERCOSUR countries would be affected by the potential volatility of the dollar/euro exchange rate. Mundell's attractive scenario considers a restructuring of the International Monetary System toward a system of fixed exchange rate parities. In a similar vein, Salvatore (2000) proposes macroeconomic policy coordination among the three main blocks¾US, Europe and Japan¾in order to avoid exchange rate misalignments that could jeopardize the stability of the international trade and financial systems. Both recommendations would create exchange rate stability, but the problem posed by Mundell is what the anchor would be. According to Kenen (1995), a scenario of cooperation is highly unlikely in the short and medium term because the European Central Bank in trying to maintain its credibility, especially since it is a new institution, would oppose it.

Both scenarios are likely to impact Euroland FDI outflows. Flam and Jannsson (in Wyplosz, 2001) study the relationship between exchange rate uncertainty and FDI. By focusing on risk aversion, these authors argue that exchange rate risk is important to FDI decisions because of the time lag between investment and profits in foreign currency. An increase in volatility may reduce future profits and therefore, FDI if the higher exchange rate instability reduces the certain equivalency of prices in foreign currency. However, if FDI is a substitute for domestic production and exports, then the opposite may result. In fact, the empirical research reviewed by these authors shows that an increase in exchange rate uncertainty has a positive

effect on FDI, although all of the studies mentioned focused on FDI from and to developed economies.

Whatever the evolution of the euro's exchange rate is with regard to its value against the US dollar and its volatility, what remains clear is that the adoption of the common currency has eliminated exchange risk and all of the costs associated with it for investors in the EU. This element together with the increased market access derived from the liberalization of capital flows could lead to capital allocation shifts out of national European markets into the EMU integrated market, although such deviation is more likely to occur for portfolio than for FDI flows (Flam and Jansson in Wyplosz, 2001). Again, the young age of the euro limits the result of any empirical analysis in this regard. However, the impact of the Single Market on capital flows should be evident by now.

Graph VII shows the evolution of EU and USA FDI flows for the decade of the 1990s. The evolution of Spanish flows has been included as a separate trend to show how the process of European integration has had a different impact on one of the major investors in the MERCOSUR region. While it is difficult to extract conclusions regarding the impact of the exchange rate variable, it remains clear that the reduction of transaction costs encouraged by the consolidation of European integration could have had a large impact during the period 1990 to 1995. However, after 1995, FDI flows into Europe show a decreasing trend to the levels of 1988.

Graph VII. FDI of European Union, Spain and United States in Europe, 1988-1999

(as a percentage of the total outflows)
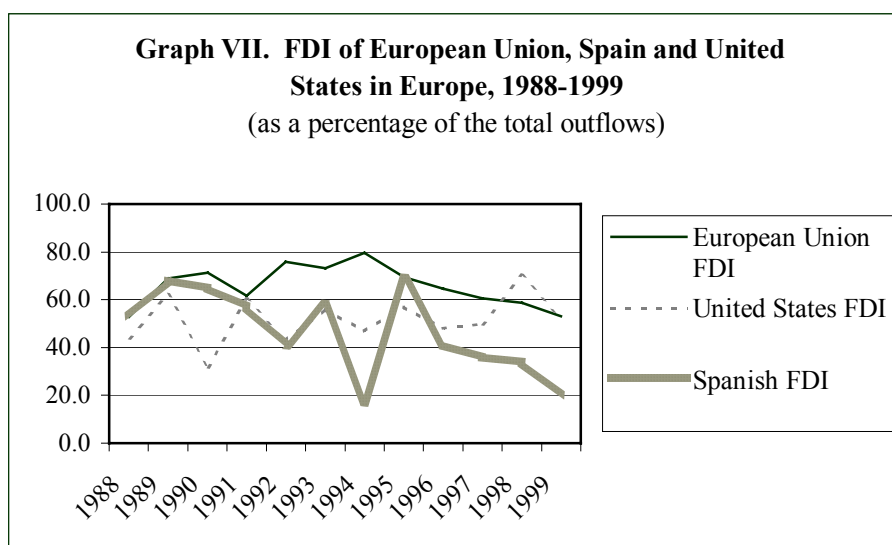
Source: Author's elaboration of data from OECD, 2000. Data for the EU is an average that does not include Greece and Ireland. FDI from Belgium and Luxembourg are calculated together.

The extrapolation of these results to the effects of the adoption of the euro seems to indicate that the impact of the introduction of the common currency on FDI flows to Europe could be significant in the short to medium term. In the long term, FDI flows to the old continent are likely to respond to a combination of micro and macroeconomic variables in which the exchange rate would only play a small role (Cohen in Wyplosz, 2001). In this sense, the evolution of the value and volatility of

the new currency is not likely to deviate potential FDI flows from MERCOSUR to Europe as a whole.

In summary, while neither the time framework nor the absence of consensus on the economic analysis allow for a definitive conclusion with regard to the impact of exchange rate movements and volatility on Euroland FDI flows, it seems clear that the adoption of a fixed exchange rate by one of the largest trading and financial groups of the world is likely to impact its capital outflows on the long-term. Moreover, exchange rate movements and their volatility will depend on the evolution of transatlantic political and economic relations. Both could be classified as "systemic elements" (Manzocchi, 1999:24), i.e., exogenous determinants of FDI that are likely to impact its volume. In this sense, policy makers in MERCOSUR countries should pay close attention not only to the effects of the introduction of the euro itself, but also to its future evolution.

c) Savings-Investment Balance

Gross domestic savings has not received much attention by the literature of FDI flows. In their seminal work, Feldstein and Horioka (1980) sustain that exogenous changes in national saving rates should have no effect on investment rates under the assumption of perfect capital mobility. Moreover, the authors find that the increments of national savings in industrial countries tend to remain in the country-of-origin. However, for the specific case of Taiwan as a source country of FDI, Lin and Szenberg (in Dunning, 1998) identify the saving surplus as one of the principal macroeconomic determinants of the increase in Taiwanese flows.

In the case of the EU, there is an excess of domestic savings relative to investment demand (Graph VIII). Investment, though stagnating, is still at a rather high level, but total savings has a tendency to increase, despite the decreasing trend observed in private savings, especially with the reduction in public sector deficits encouraged by the Maastricht Treaty. FDI flows to other regions of the world where new investment could obtain higher returns could alleviate the problem of a deflationary situation occasioned by the excess of savings. The large investment requirements in MERCOSUR countries and the fall in domestic savings observed in the region, especially in Argentina and Paraguay, create a strong potential for external financing that makes the region an apt candidate for EU FDI flows.

Graph VIII. EU-15 Gross Savings and Investment

(% of GDP at current prices)
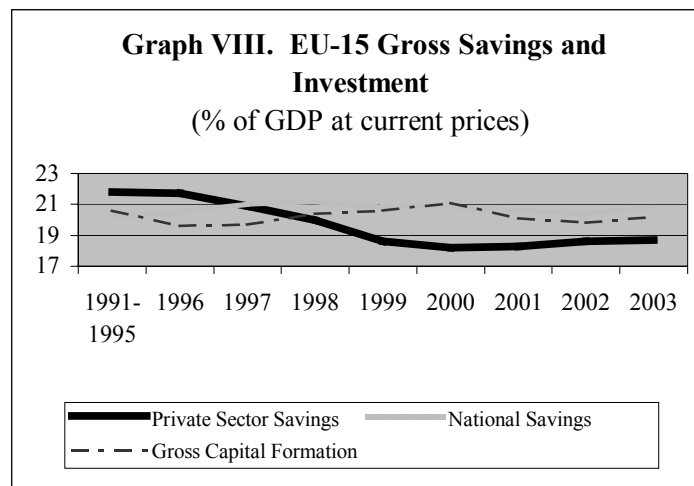
Source: Author's elaboration of data from European Commission, 2002

From a theoretical perspective, international capital flows can be explained in terms of the difference between domestic savings and investment. Following Rivera-Batiz and Rivera-Batiz (1994) presentation of the absorption approach to the balance of payments, the basic national income accounting identities can be expressed so as to include their relationship with the current account balance (CA) in the context of an open economy. Thus, considering domestic absorption (A) as the total aggregate amount spent by the residents of a given country on domestic products, the CA can be expressed as follows,

CA = Y - A (1)

The preceding identity shows that the CA is identically equal to the difference between the national output (Y) and domestic absorption. Following this identity, a CA surplus indicates an excess of national income over spending. Breaking down domestic absorption into consumption and investment and taking into account both the private and the government consumption and investment, equation (1) can be rearranged as follows,

CA = Y – (C + I + Cg + Ig)

CA = (Y- C – Cg) – (I + Ig)

CA = Gross National Savings – Gross National Investment (2)

Equation (2) reflects that a CA surplus implies an excess of gross national savings over investment. In this situation, the savings surplus will go to finance investment abroad resulting in a net outflow of capital from the country. While the interpretation of equation (2) is crucial for countries with significant external debt, such as Argentina and Brazil, it is also important for the analysis of the European countries as sources of foreign investment. Graph IX displays the relation between the European savings-investment balance and the current account. The estimates of the European Commission for the years 2002 and 2003 predict a current account surplus

encouraged by an increase in national savings that exceeds the rise in domestic investment.

Graph IX. EU-15 Current Account Balance
(% of GDP in current prices)
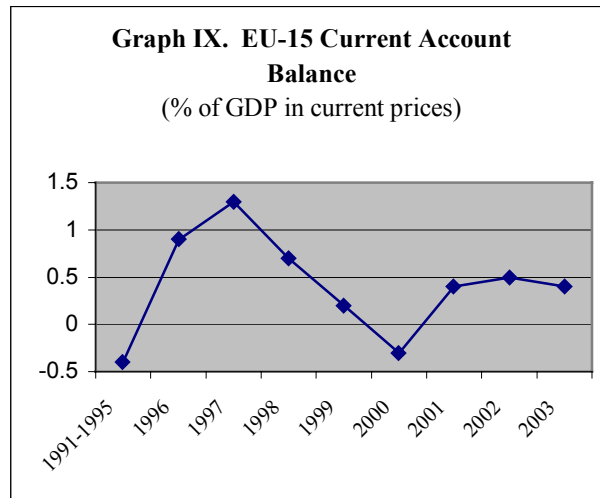
Source: Author's elaboration of data from European Commission, 2002

It is noteworthy that the literature on the determinants of national savings has not reached a consensus regarding the socio-economic factors that affect the evolution of gross domestic savings. Income level, demographic factors, pension schemes and fiscal policy are expected to impact the future level of savings (Loayza et al, 2000 and Makin, 2000) although the signs of the correlations between these variables and savings differ among studies.

In summary, the levels of excess savings displayed by the EU-15 may constitute another "push factor" that contributes to the evolution of European FDI flows to MERCOSUR countries. Despite the lack of consensus with regard to the variables that affect the dynamics of domestic savings, the estimates of the European Commission for the short-term seem to indicate that the trend of a surplus of savings reflected in the positive sign of the Current Account Balance is likely to continue within the EU. The low level of MERCOSUR savings rate, an average of 13.7 percent of the GDP for the year 2000, together with the identification of the lack of financing as a serious obstacle to business development by more than 40 percent of Argentine entrepreneurs and around 30 percent of their Uruguayan and Brazilian counterparts (IADB, 2001) indicates that the region could benefit from external financing.

THE EFFECTS OF THE ACCESSION OF THE CEE-10 TO THE EU

After decades of isolation of Eastern Europe from its Western counterpart, in June 1988 the European Economic Community signed a Joint Declaration on the Establishment of Official Relations with the COMECON countries which, while mostly political in nature, allowed the opening of economic relations between both regions. The process of dialogue between the two regions has delivered results that

were unthinkable just two decades before: the economic and political integration of Eastern and Central Europe in the EU. In 1993 the Copenhagen European Council confirmed the legitimacy of Central and Eastern European applications for membership and established the political and economic criteria for accession.

There are currently thirteen candidates for membership, ten from Central and Eastern Europe (CEE-10), plus Cyprus, Malta, and Turkey. The CEE-10 can be subdivided in two groups: (a) countries that began negotiations in 1998, including the Czech Republic, Estonia, Hungary, Poland, and Slovenia, each of which is expected to conclude negotiations at the end of 2002 and (b) countries that commenced the negotiating process in the year 2000, including Latvia, Lithuania, Slovakia, Bulgaria and Romania. Given the relatively small market size of both Cyprus and Malta and the difficulties in the negotiating process with Turkey, this investigation will focus exclusively on the impact of accession of the CEE-10.

The EU enlargement to the East is a process of historical geopolitical, social and economic consequences not only for Europe as a whole, but also for the international community. Although it is difficult to isolate the impact of the enlargement from variables such as the process of economic and political reform in the CEE-10 countries, the evolution of the global economy, and, for purposes of this investigation, the economic and political performance of the MERCOSUR countries, it is obvious that the political and economic preparation for accession to the EU and the process of accession itself have influenced the volume and distribution of FDI flows and it is likely to continue to do so in the future. The purpose of this section is to analyze the elements that could encourage a deviation of potential flows from MERCOSUR to the CEE-10 as a result of the process of enlargement, the reforms associated therewith, and the impact of enlargement on the economic dynamics of the EU.

The significant increase observed in EU FDI flows to the CEE-10 countries during the 1990s has generated a substantial amount of literature because of its potential impact on the economic structures of the recipient countries (Resmini, 2000) and because of the concentration of the flows in just a few countries (Table IV). According to the literature reviewed, the increase in the amount of direct investment allocated to the CEE-10 is considered modest and, for some, even disappointingly low once the initial small level at the beginning of the 1990s is taken into account (Sinn and Weichenrieder, 1997). The initial low base is not surprising given that most of the CEE-10 countries prohibited foreign investment during the period of central planning.

TABLE IV. INFLOWS OF FDI TO CEE-10 COUNTRIES, 1990-2000

(MILLION DOLLARS)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
BULGARIA (A)	4	56	42	40	105	90	109	505	537	806	1002
CZECH REPUBLIC	132	513	1 004	654	869	2562	1428	1300	2720	5108	4595
HUNGARY	311	1459	1471	2339	1146	4453	2275	2173	2036	1944	1700
POLAND (B)	10	117	284	580	542	1132	2768	3077	5129	6471	10
ROMANIA	..	40	77	94	341	419	263	1215	2031	1041	1025
SLOVAKIA	18	82	100	168	250	202	330	161	508	330	2075
SLOVENIA	4	65	111	113	128	177	194	375	248	181	176
ESTONIA	..	..	82	162	215	202	151	267	581	305	387
LATVIA	..	..	29	45	214	180	382	521	357	348	408
LITHUANIA	..	..	8	30	31	73	152	355	926	486	379

Source: UNECE Department of Economic Affairs, various years.

(a) For Bulgaria between 1990 and 1994, data correspond to net of residents' investment abroad.

(b) For Poland between 1990 and 1992, data correspond to net of residents' investment abroad. All data for Poland are reported on a cash basis.

Table IV shows that FDI flows have been highly concentrated during the 1990s in three countries, the Czech Republic, Hungary and Poland. In 1995, these three countries received almost 90 percent of the total annual flow to the CEE-10 economies. The literature reviewed in this regard points to the following factors as determinants of the concentration of investment in the aforementioned countries: (a) the institutional framework, the mode of privatization, and the record of servicing sovereign debt (Kaminski, 2001 and Phelps and Alden, 1999); (b) the Essen announcement (See Annex I) which, while not explicitly mentioning candidates for accession, encouraged an increase in the flows of FDI to those countries that share geographical proximity and had most significantly advanced in the process of macroeconomic and political reform (Bevan and Estrin, 2000); (c) the size of the market together with the preference of scale-intensive and high-tech FDI for the

countries more advanced in the transition process are considered by Rasmini (2000) and Tang (2000a) as elements that have encouraged the concentration of flows into the three countries; and (d) according to Estrin, Hughes, and Todd (1997), the economic growth associated with the reform period and the process of accession has encouraged foreign investors to respond to pent-up demand, especially in the Czech Republic, and to move early into the most stable countries in order to establish competitive conditions in distribution channels, consumer confidence, and alliances with domestic suppliers.

Most FDI flows into the CEE-10s originate in the EU, with Germany, Italy, and Austria playing the most active roles (UNCTAD, 2001). For the specific cases of Germany and Austria, geographical proximity, previous trade relations with some countries of the COMECON, the influence of the German reunification, language factors, cultural proximity and certain sector-specific considerations (Estrin, Hughes, and Todd, 1997; Buch, Kokta, and Piazolo, 2001, and Resmini, 2000) help to explain the flows of FDI allocated to the CEE-10 countries. The evolution of EU flows to Central and Eastern European nations has spurred a vast amount of literature that not only analyzes the causes and consequences of the increase in foreign investment, but also explores the possibility that the economic and political transformation undertaken by the CEE-10 countries has encouraged diversion of foreign investment that would otherwise have been directed toward other developing and emerging economies.

In order to extrapolate this type of analysis to the purpose of this investigation, it would be necessary to conduct a detailed study of the FDI flows to the CEE-10 countries. While such a study is outside the scope of this thesis, I present herein a simple framework in terms of relative comparative advantages¾based on variables that have been analyzed in this thesis as potential determinants of foreign investment¾for FDI flows in both regions that serves to explain, in part, the potential deviation of EU flows from MERCOSUR countries to the Czech Republic, Hungary and Poland (CEE-3).

TABLE V: FDI DETERMINANTS IN COMPARATIVE PERSPECTIVE

SOCIO-ECONOMIC CHARACTERISTICS	MERCOSUR	CEE-3
SIZE OF THE MARKET	Larger for the year 2000 (See Annex II)	
DEMOGRAPHIC STRUCTURE	Higher growth rate and younger structure (*See* Section II.A)	
INDEX OF ECONOMIC FREEDOM, YEAR 2002[12] (HERITAGE FOUNDATION)	Average of Overall Score: 2.8	Higher economic freedom: Average of Overall Score: 2.5
CORRUPTION INDEX, YEAR 2001[13] (TRANSPARENCY INTERNATIONAL)	Average of Corruption Perception Index[14]: 4.2	Average of Corruption Perception Index: 4.43

The results displayed in Table V tend to indicate that there are certain variables related to the business environment, such as corruption and the degree of economic freedom, for which the CEE-3 displays better results than the MERCOSUR countries. While such relative advantage does not imply a potential deviation of FDI flows from MERCOSUR to the CEE-3 economies, it is noteworthy that variables such as corruption, political stability and efficiency of regulations ,among others, are taken into account by European investors when evaluating FDI decisions (ERT, various years). Moreover, empirical analyses of the weight of the overall business environment in FDI decisions confirm the positive relation between a stable and efficient business framework and FDI flows (Stein and Daude, 2001 and Singh and Jun, 1995).

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[12] To measure economic freedom, the Heritage Foundation analyzes 50 independent economic variables that fall into 10 broad categories: trade policy, fiscal burden of government, government intervention in the economy, monetary policy, capital flows and foreign investment, banking and finance, wages and prices, property rights, regulation, and black market activity. The four broad categories are: (a) Free (average overall score of 1.95 or less); (b) Mostly free (2.00 to 2.95); (c) Mostly Unfree (3.00 to 3.95), and (d) Repressed (4.00 or higher). I have calculated the average presented in the table using the overall score for the MERCOSUR countries and that of the CEE-3. For a detailed analysis of each category, *see* www.heritage.org.

[13] The Corruption Perceptions Index elaborated by Transparency International considers perceptions of the degree of corruption as perceived by business people, academics and analysts. The index ranges between 10 (highly clean) and 0 (highly corrupt). I have calculated the average presented in the table using the CPI score of the MERCOSUR countries (excepting Paraguay) and that of the CEE-3. For a detailed analysis, *see* www.transparency.org.

[14] The MERCOSUR average does not include data for Paraguay since Transparency International does not report it. Paraguay's exclusion is due to the lack of surveys for the past three years. This implies that Paraguay probably has higher levels of corruption than those included in the CPI and, therefore, the MERCOSUR average (including Paraguay) may be higher than the number reported.

With regard to the educational levels¾generally used as a proxy for the skills of the labor force¾ the CEE-3 enjoy a clear advantage over the MERCOSUR countries, especially over Brazil and Paraguay. Although the preference of foreign investors for countries with a highly-educated labor force probably depends on sector-specific considerations, most of the literature reviewed in relation to FDI to transition economies coincides in pointing to the well-educated, but low-cost, labor force of the CEE-3 countries as one of the principal magnets for foreign investment attraction.   The theory of MNCs reviewed in Section II. A. of this document (Markusen, 1995 and 1998) appears to confirm the importance of the skills of the labor force in location decisions.   In this sense, the educational level of the labor force can be considered as a "location advantage" within Dunning's OLI framework.

The vast majority of the macroeconomic literature on FDI allocated to MERCOSUR economies point to the crucial role played by economic reform and macroeconomic stability in the attraction of FDI by Argentina and Brazil. While it is difficult to reach conclusions based on an static analysis of macroeconomic variables such as the consumer price index, current account balance, and/or fiscal deficit, the data in Annex IV appear to indicate that both MERCOSUR and the CEE-3 display some macroeconomic imbalances, such as high rates of inflation and significant current account deficits.   In general terms, such macroeconomic imbalances are higher for the MERCOSUR countries.   Moreover, the current economic crisis in Argentina and the efforts that the CEE-3 countries are undertaking in order to meet the criteria for accession into the EU (Annex I) may increase the relative stability in the CEE-3 vis-à-vis the MERCOSUR economies.

The accession into the EU constitutes a significant relative advantage of the CEE-3 in particular, and the CEE-10, in general, over the MERCOSUR countries in terms of determinants of FDI flows.   Although the MERCOSUR process itself has encouraged economic reform and has been perceived by foreign investors as a mechanism that enhances credibility, the accession by the CEE-10 has already delivered important results in terms of the credibility of economic reform and institutional development.   The differences between the two processes are readily apparent. While MERCOSUR is an imperfect Customs Union with nominal potential for the coordination of macroeconomic policies and erratic behavior with regard to the fulfillment of the dispositions by its members, the accession of the CEE-10 to the EU will lock the countries into the rigid monetary policy of the EMU, force the new members to adopt EU legislation in matters that will greatly improve the business environment and liberalize the vast majority of economic sectors, thereby enhancing competitiveness.

MERCOSUR countries may, however, benefit from their participation in the FTAA process. MERCOSUR's integration into the FTAA can serve as a solidifying factor given that the FTAA is compatible with the maintenance of regional and bilateral trade and investment agreements. Moreover, the benefits in terms of FDI that MERCOSUR will obtain by being part of a North-South type of accord could help reduce the economic asymmetries observed among its members. At the same time, the potential dispositions with regard to foreign investment may improve the business environment of the region.

Table V also includes a reference to the European countries with which each region has historical and cultural linkages. The predominance of Germany and Austria as host-countries of FDI allocated to the CEE-3 and the crucial role played by Spanish companies in MERCOSUR countries indicate that linguistic and cultural factors can reduce certain costs associated with the establishment of a firm in a foreign country. The significant presence of German foreign investment in Brazil and of Italian capital in the CEE-10 suggests, however, that the former colony-metropolis relations and the sharing of a common language are not sufficient to explain the non-economic links, thereby calling for more in-depth analysis.

Finally, in addition to the results of Table V, it would be necessary to complement this study with a specific-sector analysis that examines the growth potential of each productive sector in order to determine their relative attractiveness for foreign investment. Given the macroeconomic approach of this thesis, such a study does not fall within the scope hereof. However, there are some specific-sector characteristics described by Andres Inotai (in Fischer, Gleich and Grabendorff, eds, 1994) for the CEE-10 countries that can be summarized and contrasted with their MERCOSUR counterparts as follows:

(a) Greenfield investment started in the CEE-10 countries around 1992. This investment was allocated to the automotive, transport equipment, electronics, and food processing sectors. Some of the aforementioned sectors have also received foreign investment in MERCOSUR countries.

(b) The telecommunications sector in the CEE-10 countries has displayed a significant dynamism in terms of FDI flows. Given the relative superiority of the labor force skills in the CEE-10's vis-à-vis the MERCOSUR countries, this sector may continue to display high growth in the CEE-10 and receive flows of foreign investment to the detriment of its counterpart in MERCOSUR countries.

(c) Taking into consideration the link between trade and FDI, it is interesting to review the potential export products from both regions that could compete to access the European market. Table VI summarizes the principal results of Inotai's analysis.

TABLE VI: COMPETITION OF EXPORT SECTORS, MERCOSUR AND CEE-10

AGRICULTURE	Argentina, Brazil	Hungary, Poland
INDUSTRIAL RAW MATERIALS	Argentina, Brazil	Czech Rep., Slovakia
INDUSTRIAL CONSUMER GOODS	No competition expected	No competition expected
MATERIAL-INTENSIVE FINISHED PRODUCTS	Argentina, Brazil	Hungary, Poland, Czech Republic, Slovakia
CHEMICALS	No competition expected	No competition expected
MACHINERY	Brazil	Hungary, Poland, Czech Republic, Slovakia

Source: Author's elaboration from analysis of Inotai in Fischer et al, 1994.

In summary, assuming that only economic variables affect FDI location decisions¾geographical distance, political relations, cultural links and historical variables are irrelevant¾ then the accession of the CEE-10 countries to the EU may set these economies in an advantageous position as recipients of FDI over the MERCOSUR countries. To be sure, the impact of the accession on macroeconomic stability, credibility of the political and economic reforms and the business environment would attract EU FDI flows to the CEE-10 countries to the detriment of their MERCOSUR counterparts.

However, there are two additional elements that could affect the aforementioned analysis. On one hand, some researchers have argued that several enlargement announcements have already increased EU FDI flows to the CEE-10 region, thereby reducing the potential increase in greenfield investment once the enlargement process is completed (Kaminski, 2001; Bevan and Estrin, 2000; Martín et al, 2001and Buch et al, 2001). The accession process has not been followed by a balanced distribution of FDI flows among the CEE-10 countries, suggesting that integration into the EU is a necessary but insufficient condition for the attraction of foreign investment flows (Tang, 2000a). Moreover, the need for further institutional changes that create a flexible EU structure capable of absorbing a large amount of new countries, the inadequacy of the current structural funds as an instrument to balance income divergences, the protectionist bias of the agricultural interest of the current EU members, and security concerns are crucial obstacles that could still jeopardize the process of enlargement (Tang, 2000a and 2000b and Baldwin, 1994). On the other hand, MERCOSUR, countries through their participation into the FTAA process, can also obtain some of the benefits inherent to the CEE-10 entry into the EU.

Cultural, Historical, and Political Links Between Host and Source Regions: The Importance of the Framework Cooperation Agreement

The analysis of the influence of the historical-cultural links on FDI location decisions can be incorporated within the "bilateral affinities" framework (Resmini, 2000). While a significant amount of the research on FDI determinants has focused on the economic aspects of the "bilateral affinities," the examination of the political, social and cultural affinities between home and host-country is increasingly receiving attention as one of the crucial motivations in explaining the location choices of foreign investors. These types of studies are more common among scholars that utilize a sociological approach to the economic analysis, but the introduction of non-economic variables into economic analysis has also been incorporated into other approaches to economic theory.

FDI flows are contingent on institutional arrangements between the host and the home region, on their shared sets of cultural values and understandings, and on business and personal network ties between source and host countries (Chen and Chen, 1998; Boltanski in Zukin and DiMaggio, 1990; Davidson, 1980; Pio in IRELA, 1994, and Stein and Daude, 2001). According to Mira Wilkins (cited in Toral, 2001), the greater the shared cultural values and the closer the political relationships, the earlier and greater will be the multinational's interest in investing in a particular country. This is especially true for the case of Spanish FDI into MERCOSUR countries, particularly in Argentina where a common language, historical links and the existence of a large community that identifies with its Spanish roots have cut down the costs of establishing a presence in a foreign country. As mentioned in the previous section, these factors are also at the center of German and Austrian FDI decisions in some of the CEE-10 countries.

From an empirical perspective, there are several studies that use econometric models to prove the positive impact of cultural and historical links on FDI flows. In their study of determinants of FDI to the United States, Grosse and Trevino (1996) find that the greater the cultural difference with the home country, the less FDI is undertaken. Thomas and Grosse (2001) report a similar finding for the case of FDI flows to Mexico. Finally, Stein and Daude (2001) include common language and common colonial links as dummies in their empirical analysis of the determinants of FDI from 28 OECD source countries to 63 host countries. The authors find that common language has a positive impact on FDI.

The process through which cultural affinities and historical links affect foreign investment decisions is better understood under the approach of the theory of the firm. The advantages that arise from the sharing of cultural similarities and historical links between host and source country can be summarized as follows:

(a) Demand for a certain product or service will be higher in countries with similar market tastes and needs (Davidson, 1980).

(b) The existence of a common language in the source and host countries reduces costs in personnel, negotiations with suppliers, marketing campaigns, and many other daily activities of a firm that are related to

communication and information (Caves, 1996; Phelps and Alden, 1999 and Davidson, 1980). This reduction in transaction costs is accentuated by the existence of broad cultural affinities between source and host countries.

(c) The existence of corporate and individual networks between economic actors in the source and host countries facilitates all stages of firms activities (Boltanski in Zukin and DiMaggio, 1990 and Chen and Chen, 1998).

(d) Firm supply activities are also benefited by economies of scale achieved through the possibility of transferring pricing and distribution strategies, product design, packaging, marketing strategies and human resources, among others (Davidson, 1980).

In the specific cases in which the former metropolis is the source of FDI flows while the former colony is the recipient, the historical tie may be translated into political protection (Caves, 1996).

Davidson argues that some of the elements described above partially explain the significant amount of US direct investment in Canada, the United Kingdom and Australia. However, the author acknowledges that once the MNC operating in a non–similar market acquires information and experience that allow it to function with a lesser degree of uncertainty, then the "bilateral affinities" become less important. Davidson attributes this behavior to the life cycle of the firm. When firms are in the initial stage of foreign expansion, it is expected that they will display a high preference for similar markets. Once the firm has acquired significant experience in foreign markets, then cultural affinities and historical links are not as relevant for the location decision process.

In the case of MERCOSUR, Davidson's argument could well explain the high degree of preference for Latin America displayed by Spanish companies. To be sure, the strengthening of the process of internationalization of Spanish companies can be traced only to the mid-80s and, therefore, these firms could be classified as being in the initial stages of foreign expansion. However, it is noteworthy that some of the most important Spanish firms that have a presence in MERCOSUR countries, such as REPSOL and Telefónica, have also invested in countries with weak historical links or cultural similarities with Spain. Moreover, several studies have pointed to the strong historical links between Europe and its former colonies as one of the crucial determinants of the relative investment preference of EU members for certain regions independently of the "age" of the MNC (IRELA, 1994 and 1998; Shatz and Venables, 2000 and UNCTAD, 1998).

In his review of the historical evolution of European FDI, Vernon (in Froot, 1993) argues that European firms have tended to establish subsidiaries in countries with close political ties with their home governments. The evolution of political relations between MERCOSUR and the EU has evolved significantly in the last two decades. The remainder of this section will briefly describe the dynamics of politico-economic cooperation between both regions that resulted in the signing of the Framework Cooperation Agreement and the principal characteristics of this agreement.

The accession of Spain and Portugal to the EC in 1986 is generally considered as a turning point in the political-economic relations between the EU and Latin America in general, and MERCOSUR in particular. Although several European countries had maintained economic relations with Latin America prior to such time, especially from the financial perspective, the EC policies focused until the mid-80s on the former colonies in Asia and Africa (Kaufman Purcell and Simon, 1995). The Spanish interest in its former colonies is not the only factor that played a role in the European "rediscovery" of Latin America. The return to democratic practices, the revitalization of integration processes and symptoms of economic recovery after the so-called "lost decade" encouraged the EU to wake up from decades of disinterest in Latin America.

The creation of MERCOSUR in 1991 coincided with a radical change in the EU design of foreign policy. To be sure, the EU replaced the old "continental" strategy of foreign relations with that of "biregional relations" (Grabendorff in Roett, 1999 and Bonalumi in Molina del Pozo, 1996). It is in such biregional context that the political-economic dialogue between both regions began to evolve and to materialize into concrete results both in the political and economic arenas (See Annex VII).

The signing in 1995 of the EU-MERCOSUR Framework Cooperation Agreement in Madrid can be considered as an inflexion point. On one hand, it was the result of several years of political and economic dialogue between both blocks. On the other hand, the main objective of the accord was the preparation for negotiations of the Interregional Association Agreement that were launched in 1999 in Rio de Janeiro at the first Latin America and Caribbean-EU Summit. This type of agreement has been characterized by many scholars as following a "North-South" pattern. Fernandez-Arias and Spiegel argue, for the case of NAFTA, that a North-South trade agreement may improve the ability of the Southern nations¾MERCOSUR in this case¾ to attract capital through the enhanced credibility stemming from the agreement and through commitments about the treatment of foreign investment. However, in the case of MERCOSUR, it is probable that the countries have already benefited from enhanced credibility due to the integration process itself and to the economic reforms undertaken during the 1990s.

By the same token, Venables (1999) contends that developing countries will obtain more economic benefits by entering into a regional trade agreement with high-income members (North-South) than by associating themselves with partners that display similar levels of income (South-South). Venables supports his argument by claiming that a North-South type of agreements is likely to lead to economic convergence, while South-South agreement can lead to real income loss for the lowest income members due to trade diversion. Finally, it appears that the EU investors are positively evaluating the prospects of association between the EU and MERCOSUR. According to an enquiry undertaken by Krumwiede and Nolte (1998) among 31 executives of 21 German companies¾ most of them MNCs¾, there is a positive perception of the increasing close political and economic ties between the EU and MERCOSUR and the corresponding impact on German FDI to the region.

Most of the literature reviewed points to similar geopolitical and economic reasons that explain the fundamentals of the Association Agreement between the EU and MERCOSUR, the first to be signed between two Custom Unions. From the MERCOSUR perspective, the EU is its principal trade partner (See Annex X). In 1991 almost 22 percent of MERCOSUR imports came from the EU, a percentage similar to that of the United States and above that of MERCOSUR itself (15 percent). By the year 2000, MERCOSUR imports from the EU accounted for 24 percent of total again surpassing the United States (20 percent) and MERCOSUR (20 percent) as the source of imports. With regard to exports, in 1991 MERCOSUR exports to the EU amounted to 32 percent of the total, while less than 11percent went to MERCOSUR and 17 percent to the United States. Although MERCOSUR exports to the EU displayed an increasing tendency during the 1990s, the European market reduced its share as recipient of MERCOSUR exports by the year 2000 to 23 percent, primarily due to the increase in exports among MERCOSUR countries (21 percent).

According to Bouzas and Svarzman (2000) and Reis Castilho (in Da Motta Veiga, 2000), EU-MERCOSUR trade flows follow a classic North-South pattern reflected by a very low coefficient of intra-industry trade. EU imports from MERCOSUR are highly concentrated in food, agricultural and fishery products. For the year 2000, an average of 35 percent of MERCOSUR exports to the EU were commodities, while over 45 percent of EU's exports to the region fall under the category "diffusers of technical progress." Such asymmetry could harm MERCOSUR for two reasons. First, it forces the region to be highly dependent on the export of commodities, thereby introducing an element of uncertainty due to the wide fluctuation of the international prices of commodities. Secondly, MERCOSUR would have to confront a highly protectionist Common Agricultural Policy (CAP) that subsidizes many of the products that MERCOSUR could export tariff-free to the EU. Moreover, the accession of the CEE-10 to the EU could reduce some of the comparative advantages of MERCOSUR commodities.

MERCOSUR association with the EU also provides improved market access, although conditioned on the future evolution of the CAP, larger capital inflows through the investment promotion clause contained in the framework agreement (Buxedas, 1995), and more credibility at the international level. Finally, according to Bulmer-Thomas (1999) and Reis Castilho (in Da Motta Veiga, 2000), MERCOSUR countries, especially Brazil, also consider the bargaining advantages of an agreement with the EU. In this sense, extracting concessions during the FTAA rounds of negotiations could be easier if the prospects of a MERCOSUR-EU free trade area are on "the table."

From the EU perspective, an agreement with MERCOSUR is a viable mechanism to secure the market-oriented reforms that have been implemented in the region since the beginning of the 1990s. Such reforms are enhancing investment opportunities, especially through privatization, on which the EU has embarked in the region. The EU companies that are already established in MERCOSUR countries would highly benefit from an FTA between the two blocs for they would enjoy tariff-free imports and exports to the EU market (Estevadeordal and Krivonos, 2000). Finally, the EU seeks to avoid the potential losses with respect to its interests in the Western Hemisphere that would be associated with a successful FTAA (Campbell,

1999). Its experience with the loss of a significant Mexican market share after the signing of NAFTA is encouraging the adoption of a defensive position and a trade and investment agreement with MERCOSUR is part of such defensive strategy.

With regard to the current situation of the Association Agreement, it is noteworthy that the chapters on political dialogue and cooperation are almost finalized. The approval of the trade chapter, however, is being delayed given the difficulties in reaching an agreement in areas such as agricultural products (Diario El País; May 16, 2002).   There also differences with regard to the timing of the approval of the final document of the agreement. While the EU prefers to wait until the end of the WTO Round, the MERCOSUR countries want to finalize negotiations by 2004 in what appears to be an attempt to improve their bargaining position at the FTAA table.   These differences also reflect the divergence in priorities for both blocks. Although MERCOSUR is engaged in several external negotiations, the EU's external agenda is extremely complicated and, the accession negotiations are currently at the top of the external preferences pyramid, reflecting what Reis Castilho defines as "opção pelos vizinhos" (preference for the neighbors).

There is one final element that is worth mentioning within the context of the political relations between the EU and MERCOSUR. Since the beginning of the process of formal political dialogue, the EU has encouraged FDI flows to Latin American countries in general, and to MERCOSUR economies in particular through its programs on economic cooperation, specifically in respect of business and industrial cooperation.   Before the Spanish accession, the EC contemplated preferential treatment for some Latin American exports.   However, the more preferential treatment given to the Lomé countries placed the exports from Latin America at a disadvantageous position (Kaufman Purcell and Simon, 1995). Although the Spanish entry into the EC and its interest in strengthening political and economic relations with the Latin American region did not achieve the extension to the region of the preferences granted to the Lomé countries, it certainly encouraged the establishment of cooperation agreements and the commencement of loan operations through the European Investment Bank.   Table VII displays the characteristics of the principal cooperation programs established by the EU that include MERCOSUR countries.

TABLE VII. EU COOPERATION PROGRAMS WITH LATIN AMERICA

PROJECT	TIME PERIOD	MAIN OBJECTIVE	RESULTS
EUROPEAN COMMUNITY INVESTMENT PARTNERS	1988-1999	To facilitate the creation of joint ventures	More than 150 projects
AL-INVEST	1994-2000	To foster transfers of technology and finance and establish business partnerships	More than 40 investment agreements and 30 annual biregional encounters
ALURE	1995-2003	To establish cooperation in the energy sector	25 projects between 1996 and 2001
ALFA	2002-2010	Academic cooperation program	
ALIS	2001-	Promotion of information society	

Sources: Cox and Chapman, 1999; Toral, 2001 and European Commission, European Aid Co-operation Office.

In addition to the cooperation programs, the European Investment Bank (EIB) created a new fund in 1993 to finance certain investments in Latin America and Asia on a trial basis, such as the financing of joint ventures that link European and local firms. During the year 2001, there were several projects presented to the EIB for financing involving MERCOSUR countries. Those approved include Autopista del Oeste, Aguas Argentinas II in Argentina and Veracel Forestry in Brazil (EIB project list, 2002).

While it is difficult to evaluate the particular impact of the European Cooperation projects on FDI flows to MERCOSUR countries, it is noteworthy that, besides the financial aid, these type of programs are generally considered as having an enhancing-credibility effect and may propel a multiplying effect as a result of an increase in the number of contracts generated. Moreover, taking into account that some of these projects, especially those financed by the EIB, are allocated to infrastructure modernization, the projects enhance the attractiveness of the recipient countries in the eyes of foreign investors (IRELA, 1994).

In summary, cultural and historical links and political relations all play a critical role in engendering, and have a positive impact on, FDI flows by reducing transaction costs, creating more stable and transparent conditions for foreign investors, and establishing long-term commitments in economic and political terms.

FINAL REMARKS

This document has demonstrated that the current macroeconomic approach to FDI flows has not paid enough attention to the country-of-origin determinants of such flows. This deficiency is especially relevant when analyzing the specific case of FDI flows sourced in developed countries and allocated to developing economies. It is noteworthy that given the high degree of internationalization of the world economy, it is extremely difficult to isolate single variables that impact FDI flows.

By focusing on the EU as region-of-origin and the MERCOSUR as host-region, I have identified several country-of-origin variables that may have an impact on EU FDI flows to MERCOSUR economies. The following equation shows the principal variables identified as determinants, or potential determinants, of EU outflows to MERCOSUR countries. The indicators in brackets beneath the variables indicate the expected signs for the coefficients according to the results of this investigation.

$$FDI\,(M)_{M,E} = \alpha + \beta Y_E + \chi \Delta Y_E + \delta \Delta I_E + \varepsilon \Delta B_E + \phi \Delta ER_E + \gamma \Delta SS_E + \eta CEE\text{-}10 + \iota POL$$

$$\quad\quad\quad (>0) \quad\quad (>0) \quad\quad (<0) \quad\quad (>0) \quad\quad (?) \quad\quad (>0) \quad\quad (?) \quad\quad (>0)$$

Where:

FDI(m)m,e = FDI outflows in MERCOSUR (m) from EU (e).

Ye = Market size of EU.

DYe= EU GDP growth.

Die= EU cost of borrowing relative to that of MERCOSUR economies.

DBe = Convergence of bond yield in the EU.

DEre= Variations in the euro exchange rate vis-à-vis the US dollar.

DSse= Saving surplus in the EU relative to the investment-savings balance of MERCOSUR.

CEE-10: Reflects the potential impact of the accession of the Eastern European countries to the EU on FDI.

POL: Reflects the socio-political relations between the EU and MERCOSUR.

ANNEX I. EVOLUTION OF THE EUROPEAN ENLARGEMENT PROCESS

❑ 1988: Joint Declaration on the Establishment of Official Relations between the COMECON and the EC.

❑ 1991-1996: Signing of Association Agreements aimed toward the creation of an appropriate framework for the gradual integration of the applicant countries into the EC: Hungary and Poland in 1991; Czech Republic, Romania, Bulgaria and Slovakia in 1993; Estonia, Latvia and Lithuania in 1995 and Slovenia in 1996.

❑ 1992: Signing of the Maastricht Treaty that creates a new institutional framework, the EU, and acknowledges the intention of enlargement to the East.

❑ 1993: Copenhagen European Council establishes the legitimacy of Central and Eastern European applications for membership and sets forth the legal, political and economic criteria for accession.

❑ Legal Criterion: Ability of the candidates to adapt the EU legislation.

❑ Political Criteria: Stable institutions able to guarantee democracy, the rule of law and respect for human rights.

❑ Economic Criteria: A functioning market economy and the ability to cope with competitive pressures and market forces. The requisites established were those set forth by the Maastricht Treaty.

❑ 1994: Essen European Council establishes a pre-accession strategy to prepare candidate countries for accession.

❑ 1994-1996: Presentation of applications for membership by Hungary and Poland (1994); Romania, Slovakia, Latvia, Estonia, Lithuania and Bulgaria (1995) and Czech Republic and Slovenia (1996).

❑ 1997: Luxembourg European Council approves the Agenda 2000 that explores the future of the main areas of Community policy, the financial perspectives for the period 2000-2006 and the EU enlargement. It represents the official beginning of the enlargement process.

❑ 1998: London European Conference for the UE enlargement establishes the creation of a multilateral forum for political consultations on common foreign and security policy, justice and economic cooperation.

❑ 1999: Helsinki European Council decides to convene intergovernmental conferences during the year 2000 to open negotiations with Romania,

Slovakia, Latvia, Lithuania, Bulgaria and Malta on the criteria for membership. The former system of different timetables for negotiations was blamed for creating significant economic distortions among the aforementioned countries.

❑ 2000-2001: Signing of the Nice Treaty designs a new institutional framework for the enlarged EU. The Treaty establishes that the EU would be able to receive the applicant countries that fulfill the criteria as of the end of 2002.

❑ 2001: Gothenburg Summit establishes that those candidates that had completed the negotiating process could participate in the 2004 European Parliamentary elections. Despite the negative outcome of the Irish referendum on the Treaty of Nice and widespread skepticism in other member countries with regard to the future of the UE, the participants at the Summit send a clear signal that the enlargement process would continue.

Sources: Deutsche Bank Research, various years, Tang, 2000a and European Commission, Activities of the EU.

Annex II. MERCOSUR and CEE-3 Comparative Market Size

GNI per capita 2000, Atlas Method (current US$)

Argentina	7460
Brazil	3580
Uruguay	6000
Paraguay	1440
MERCOSUR	18480
Hungary	4710
Poland	4190
Czech Republic	5250
CEE-3	14150

Source: World Bank Data. GNI (formerly GNP per capita) is calculated used the Athlas method of conversion to smooth fluctuations in prices and exchange rates. The Atlas method applies a conversion factor that averages the exchange rate for a given year and the two preceding years, adjusted for differences in rates of inflation between the country and the G-5 countries (France, Germany, Japan, the United Kingdom, and the United States).

ANNEX III. EDUCATIONAL LEVEL IN COMPARATIVE PERSPECTIVE EDUCATIONAL ATTINMENT OF THE TOTAL POPULATION AGED 25 AND OVER, 1990-2000

Country	Year	Highest level attained					Average
		No	Second Level		Post-Secondary		Years
		Schooling	Total	Complete	Total	Complete	of School
Argentina	1990	4.8	30.7	10.0	13.2	5.1	8.13
	1995	4.1	31.6	10.3	16.1	6.3	8.46
	2000	3.6	31.1	10.1	20.1	7.8	8.83
Brazil	1990	18.7	11.3	3.6	6.1	3.0	4.02
	1995	17.7	11.6	3.7	6.7	3.3	4.45
	2000	16.0	14.4	4.6	7.5	3.7	4.88
Paraguay	1990	7.0	25.0	12.2	6.6	3.8	6.14
	1995	6.7	24.4	11.9	7.2	4.2	6.10
	2000	5.7	24.1	11.7	7.8	4.5	6.18
Uruguay	1990	4.6	35.6	8.2	10.2	4.9	7.09
	1995	5.1	35.8	8.3	12.2	5.8	7.31
	2000	5.1	35.5	8.2	14.6	7.0	7.56
Czech Rep.	1990	0.3	58.3	19.7	7.1	5.0	9.15
	1995	1.1	59.1	19.7	8.6	5.5	9.33
	2000	2.1	59.1	20.3	10.5	6.8	9.48
Hungary	1990	1.2	35.8	11.2	8.8	7.2	8.93
	1995	2.4	39.7	12.5	10.1	8.4	8.83
	2000	2.4	41.7	13.1	12.1	10.0	9.12
Poland	1990	1.3	48.4	16.1	6.5	4.0	9.47
	1995	1.5	51.3	17.0	8.2	5.0	9.64
	2000	1.9	53.7	17.8	10.2	6.2	9.84

| Country | Year | No Schooling | Highest level attained | | | | Average Years of School |
| | | | Second Level | | Post-Secondary | | |
			Total	Complete	Total	Complete	
Argentina	1990	5.7	25.3	10.5	12.0	7.2	7.77
	1995	6.3	24.9	10.4	16.2	9.7	8.12
	2000	5.8	24.9	10.4	19.7	11.9	8.49
Brazil	1990	22.4	9.1	3.7	7.2	4.9	3.76
	1995	22.1	11.2	4.5	7.9	5.3	4.17
	2000	21.2	13.5	5.4	8.4	5.7	4.56
Paraguay	1990	8.7	19.7	10.0	7.5	6.0	5.78
	1995	9.7	19.1	9.7	7.7	6.1	5.73
	2000	9.8	18.1	9.2	8.3	6.6	5.74
Uruguay	1990	5.5	26.8	7.8	11.5	7.9	6.69
	1995	3.4	31.7	9.2	10.0	6.8	6.88
	2000	3.2	32.1	9.3	12.5	8.5	7.25
Czech Rep.	1990	0.3	58.6	23.1	8.5	7.3	9.39
	1995	1.1	54.8	21.6	9.3	8.0	9.29
	2000	1.3	55.2	21.7	10.8	9.3	9.46
Hungary	1990	1.3	29.0	11.4	10.1	9.7	8.71
	1995	1.7	31.8	12.5	10.5	10.1	8.52
	2000	2.0	34.7	13.6	12.0	11.6	8.81
Poland	1990	1.5	47.8	18.8	7.9	6.8	9.60
	1995	1.7	48.5	19.1	9.3	8.0	9.73
	2000	1.7	49.5	19.5	11.1	9.6	9.90

Source: Barro and Lee, 2001.

MACROECONOMIC STABILITY DATA, 1999-2000

	Consumer Prices (% change)	Total Debt (% of GDP)	Government Surplus or Deficit (% of GDP)	Current Account Balance (% of GDP)
Argentina				
1999	-1.2	51.5	-2.6	-4.2
2000	-0.8	51.4	-2.4	-3.1
Brazil				
1999	4.3	45.6	-6.8	-4.8
2000	8.5	39.7	-3.2	-4.1
Paraguay				
1999	6.8	32.5	-3.6	-0.8
2000	8.9	36.2	-4.6	-4
Uruguay				
1999	5.6	36	-3.8	-2.8
2000	4.8	44.6	-4	-2.4
Czech Rep.				
1999	2.1	41.6	-0.6	-1.6
2000	3.9	45.4	-3.3	-4.7
Hungary				
1999	10	61.7	-3.4	-4.3
2000	9.7	63.1	-3.4	-3.3
Poland (a)				
1999	7.3	41	-2	-8
2000	10.1	42	-2.2	-6.3

Source: World Bank Data. (a) Data for Current Account Balance for Poland is from Deutsche Bank Research.

ANNEX V. PROBABILITIES OF ACCESSION INTO THE EU BY CEE-10

CEE-10 ACCESSION PROBABILITIES (IN PERCENTAGE)					
	2003	2004	2005	2006	2007
CZECH REPUBLIC		40	85	95	100
ESTONIA		30	75	95	100
HUNGARY	20	40	85	95	100
LATVIA			50	95	100
LITHUANIA			50	95	100
POLAND		10	75	95	100
SLOVAKIA		10	75	95	100
SLOVENIA	20	40	85	95	100
BULGARIA					AFTER 2008
ROMANIA					AFTER 2008

Source: Deutsche Bank Research, 2001.

Annex VI. FDI Flows from Germany and Italy in Comparative Perspective

Germany: Direct Investment Abroad, 1990-1999

(Millions of Deutsch Marks)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999(A)
MERCOSUR										
Argentina	-18	347	-130	82	230	452	1321	565	428	436
Brazil	175	320	284	-203	726	1696	928	645	2000	2091
CEE-10										
Baltic Countries			4	13	16	38	38	84	52	70
Bulgaria		17	5	8	98	9	39	62	81	92
Czech Republic			572	721	1138	1167	1085	1616	1450	651
Hungary	206	416	854	926	960	1526	1331	1108	2325	442
Poland	8	68	170	471	420	818	2376	2502	3741	4068
Romania		1	12	7	16	38	88	153	318	80
Slovakia				90	77	185	290	145	683	483
Slovenia			3	129	36	33	35	44	44	66

Source: UNCTAD, 2000. (a) Data for 1999 is provisional.

Italy: Direct Investment Abroad, 1992-1999

(Billions of Liras)

	1992	1993	1994	1995	1996	1997	1998	1999 (A)
MERCOSUR								
Argentina	12	14	83	103	219	71	190	157
Brazil	19	-111	-92	84	12	365	1258	453
CEE-10								
Baltic Countries	..	..	2	..	5	7	6	1
Bulgaria	1	1	1	1	1	2	2	6
Czech Republic	54	18	17	19	18	27	32	18
Hungary	33	80	36	93	67	73	25	38
Poland	27	483	60	31	21	22	55	1015
Romania	-33	5	7	11	10	34	70	31
Slovakia	..	..	..	4	10	19	6	7
Slovenia	..	10	7	13	11	22	5	3

Source: UNCTAD, 2000. (a) Data for 1999 is provisional.

❑ 1984: The EC issues "Guidelines for the Strengthening of Relations between the Community and Latin America." It constitutes the first document containing a set of criteria for relations between both regions.

❑ 1986: Spain and Portugal become members of the EC. The unilateral declaration annexed to the Spanish Adhesion Treaty included a reference to the Spanish interest in Latin America.

❑ 1986: European Council at the Hague advocates the strengthening of the links between the EC and Latin America.

❑ 1987: First informal meeting between the EC and the Rio Group takes place.

❑ 1989: Granada Meeting opens up of the political dialogue between the EC and the Rio Group.

❑ 1990: Rome Ministerial EU-Grupo de Rio Meeting. First formal EU-Grupo de Rio meeting. The meeting marks the institutionalization of the dialogue between both regions.

❑ 1991: Asunción Treaty. Creation of MERCOSUR.

❑ 1991: Luxembourg Ministerial EU-Grupo de Rio Meeting.

❑ 1992: Guimaraes Meeting between Foreign Relations Ministers of EU and MERCOSUR. This meeting is the immediate antecedent of the Cooperation Agreement.

❑ 1992: Santiago de Chile Ministerial EU-Grupo de Rio Meeting during which the Interinstitutional Cooperation Agreement is signed. The Agreement includes the following goals:

   Information Exchange

   Technical Assistance

   Personnel Training

   Institutional Support

❑ 1992: Santiago de Chile Ministerial EU-Grupo de Rio Meeting during which the Interinstitutional Cooperation Agreement is signed. The Agreement provides technical and institutional support to the MERCOSUR structure.

❑ 1993: Copenhague Ministerial UE-Grupo de Rio Meeting.

- ❑ 1994: Corfu Meeting of the European Council. The Commission states the need to reinforce relations between EU and MERCOSUR in order to consolidate and increase Europe's position in the region and to reduce the "threat" of NAFTA extension.

- ❑ 1994: Miami Summit of the Americas. It reinforces EU's interest in consolidating its position in Latin America.

- ❑ 1994: UE-Grupo de Rio Meeting in Sao Paulo.

- ❑ 1995: UE-Grupo de Rio Meeting in Paris.

- ❑ 1995: Signing of the EU-MERCOSUR Framework Cooperation Agreement in Madrid. The main objective of the agreement is the preparation for negotiations on the Interregional Association through the inclusion of three principal elements (See Annex IX):

  Political Dialogue

  Cooperation

  Trade Issues

- ❑ 1996-2001: Annual Joint Ministerial Meetings between the EU and MERCOSUR in the context of political dialogue.

- ❑ 1998: High-level official EU-MERCOSUR Meeting considers how to include Chile and Bolivia (associated to MERCOSUR since 1996) in the political dialogue between the EU and MERCOSUR.

- ❑ 1999: First Latin America and Caribbean-EU Summit in Rio de Janeiro. Joint Communiqué of EU and MERCOSUR Heads of State in which it is agreed to launch negotiations on the Interregional Association Agreement.

- ❑ 1999: First EU-MERCOSUR Council Meeting in Brussels marks the effective commencement of negotiations. The main forum for negotiations is the EU-MERCOSUR Biregional Negotiations Committee.

- ❑ 2000-2002: Seven Rounds of Negotiations in the Biregional Negotiations Committee.

- ❑ May 2002: Second Latin American and Caribbean-EU Summit in Madrid. The Summit will mark the conclusion of negotiations for an Association Agreement between the EU and Chile.

Sources: Bizzozero and Vaillant, 1996; Devlin, 2000; EU Commission. External Relations; Grupo de Rio and IRELA, 1994.

ANNEX VIII. MERCOSUR-EU FRAMEWORK COOPERATION AGREEMENT

TRADE

- o   Dialogue on Trade and Economic Matters

- o   Cooperation on Agri-food and Industrial Standards and Classification

- o   Customs Matters

- o   Statistical Matters

- o   Intellectual Property

ECONOMIC COOPERATION

- o   Cooperation in Business

- o   Promotion of Investment

- o   Energy

- o   Transport

- o   Science and Technology

- o   Telecommunications and Information Technology

- o   Cooperation in Environmental Protection

ENCOURAGING INTEGRATION

INSTITUTIONAL COOPERATION

OTHER AREAS OF COOPERATION

- o   Training and Education

- o   Information, Communications and Culture

- o   Drug Trafficking

- o   Other by Natural Agreement

Source: Devlin (2000:20)

ANNEX IX. MERCOSUR-EU INTERREGIONAL ASSOCIATION AGREEMENT

POLITICAL DIALOGUE

- o Peace and Stability
- o Protection of Human Rights, Democracy and Rule of Law
- o Sustainable Development
- o Actions in Drug and Arms Traffic, Organized Crime and Terrorism

COOPERATION

Trade

- o Group 1: Market Access
- o Group 2: Services, Intellectual Property and Investment
- o Group 3: Government Procurement, Competition and Dispute Settlement.

Economic

- o Industrial and Energy Cooperation
- o Services
- o Investment Promotion
- o Macroeconomic Policy
- o Transport and Telecommunications
- o Agriculture and Fisheries
- o Customs Procedures
- o Environment and Consumer Protection
- o Technical Regulations
- o Scientific and Technological Cooperation

Social and Cultural Cooperation

  o   Education and Training

  o   Social Dialogue and Culture

  o   Drugs and Organized Crime

Financial and Technical

  o   Public Administration Modernization

  o   Inter-Institutional and Regional Integration Cooperation

Source: Devlin (2000:21)

ANNEX X. MERCOSUR MAIN TRADE PARTNERS

MERCOSUR IMPORTS

(MILLIONS OF US DOLLARS)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
MERCOSUR	5	7	9	12	14	17	21	20	15	18
UNITED STATES	7	8	10	12	15	17	21	21	17	18
EUROPEAN UNION	7	9	11	16	20	22	26	27	23	21
TOTAL EXTRA MERCOSUR	27	32	37	48	62	66	78	75	46	69
TOTAL	32	39	46	60	76	83	99	96	80	87

Source: Centro de Economía Internacional, 2002.

MERCOSUR EXPORTS

(MILLIONS OF US DOLLARS)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
MERCOSUR	5	7	10	12	14	17	21	20	15	18
UNITED STATES	8	9	10	11	11	11	12	12	14	16
EUROPEAN UNION	15	15	14	17	18	18	19	20	19	20
TOTAL EXTRA MERCOSUR	41	43	44	50	56	58	63	61	59	67
TOTAL	46	50	54	62	70	75	83	81	74	85

Source: Centro de Economía Internacional, 2002

ANNEX XI. MERCOSUR: SAVINGS-INVESTMENT BALANCE

		1992	1993	1994	1995	1996	1997	1998	1999	2000(A)
	GROSS FIXED CAPITAL FORMATION	17.1	18.6	20.0	17.9	18.5	20.1	20.7	18.7	17.2
ARGENTINA	GROSS NATIONAL SAVINGS	14.3	14.7	15.2	15.9	15.7	15.3	15.0	13.5	13.4
	EXTERNAL SAVINGS	2.9	4.0	4.8	2.1	2.8	4.8	5.7	5.2	3.8
	GROSS FIXED CAPITAL FORMATION	18.9	20.2	21.5	22.3	22.4	23.3	24.0	22.0	21.5
BRAZIL	GROSS NATIONAL SAVINGS	19.6	19.8	20.7	19.3	18.7	18.3	18.7	18.2	18.1
	EXTERNAL SAVINGS	- 0.7	0.4	0.8	3.0	3.7	5.0	5.3	3.8	3.5
	GROSS FIXED CAPITAL FORMATION	23.2	23.1	23.4	23.9	23.7	22.7	21.8	21.1	21.1
PARAGUAY	GROSS NATIONAL SAVINGS	14.6	15.2	7.4	9.9	8.7	7.2	7.1	11.2	10.2
	EXTERNAL SAVINGS	8.6	7.9	16.0	14.0	15.0	15.5	14.7	9.9	10.9
	GROSS FIXED CAPITAL FORMATION	13.0	13.7	14.5	15.4	14.3	14.6	15.8	15.0	13.3
URUGUAY	GROSS NATIONAL SAVINGS	12.9	12.2	12.0	14.2	13.1	13.2	13.3	12.0	10.1
	EXTERNAL SAVINGS	0.1	1.6	2.5	1.2	1.2	1.4	2.4	3.0	3.2

Source: ECLAC Macroeconomic Database. (a) Preliminary data.

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