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## MERCOSUR: A new approach to regional integration?

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Kiel Working Paper No. 746

**MERCOSUR: A New Approach  
to Regional Integration?**

by

Federico Foders

May 1996



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This paper has been prepared for a symposium on "The Transformation of Latin America" held at the Universidad de los Andes, Bogotá, Colombia, on 27 and 28 March 1996. Comments received from symposium participants are very much appreciated. The usual caveat applies.

## **Abstract**

The purpose of this paper is to empirically analyze the economic potential associated with MERCOSUR. Simple import share analysis indicates increasing trade flows between the member states; ex post income elasticities of import demand fail to detect a clear pattern. Estimates of technological specialization reveal a great potential for intra-industry trade between member states. The most important challenge to MERCOSUR seems to be the still uncertain ability of member states to sustain macroeconomic stabilization in the long run.

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## **I. Introduction**

The 1980s and the 1990s have given strong testimony of a global resurgence of regionalism. Latin America seems to have been no exception to this wave. Economic integration initiatives are not new to the Americas, where the Treaty of Rome (1957) had an almost immediate impact on trade policy by serving as an inspiration for the Treaty of Montevideo which established the Latin American Free Trade Association (LAFTA) in 1960; a number of other (sub)regional schemes followed later. Given that Latin American integration schemes never matched the great success achieved by the European Community, it is legitimate to ask whether the Treaty of Asunción establishing the MERCOSUR, the most recent initiative grouping Argentina, Brazil, Paraguay and Uruguay, represents a new approach to regional integration and, if so, what the economic potential of this new approach might be. The aim of the paper is to try to find answers to these questions. The next section reviews the Latin American record with respect to regional integration. Section III presents some data and empirical estimates for an *ex ante* assessment of the economic potential of MERCOSUR and of the policy conditions on which it rests. In the last section, the main conclusions are summarised.

## **II. Regional Integration in Latin America**

In analysing regional integration schemes, economists have asked very different questions about the genesis and the impact of discriminatory trade arrangements, thereby having in mind the interests of both the member countries and third countries.<sup>1</sup> Concerning the reasons for integration, Richard E. Baldwin (1995), reports that the recent rebirth of regionalism in the world economy has been generally attributed to two major influences: (i) to a loss of credibility experienced by multilateral trade negotiations as an instrument to handle the trade issues affecting a large number of countries in a satisfactory manner and (ii) to a shift in the trade policy orientation of the United States from an unconditional supporter of free trade and multilateral negotiations to a country increasingly engaged in "aggressive unilateralism" (Bhagwati, Patrick 1991). Not surprisingly, Baldwin finds a number of flaws in both explanations and puts forward a third hypothesis. The results of the Uruguay Round of the GATT turned out to be not as bad as some had expected (Schott 1994) and, in spite of the strong recommendations of some policy economists to embrace strategic trade policies (Tyson 1992), the US Government is still fighting for what may be called the "basic rights" in international trade in goods, services and technology.

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<sup>1</sup> See the excellent survey written by Tovas (1991).

Baldwin's domino theory of regionalism argues that "an idiosyncratic shock, such as the deeper integration of an existing regional block, can trigger membership requests from countries that were previously happy to be nonmembers" (Baldwin 1995, p. 460). The idiosyncratic event referred to by Baldwin in relation with Latin America is the US-Mexico Free Trade Agreement (FTA). This event is said to have "destroyed the status quo of trade relations in the Americas" (Baldwin 1995, p. 460) and to have created incentives for membership in the FTA, especially for those Latin American countries whose exports depend to some extent on the unrestricted access to the US market. The failure of negotiations between several Latin American countries and the US on similar bilateral FTAs is hypothesised by Baldwin (1995, p. 460) to have contributed to the increased interest in (sub)regional integration in Latin America, as a possible first step towards a FTA extending from Alaska to Tierra del Fuego.

Even if the domino theory explanation for the emergence of MERCOSUR were to be conceded some plausibility, particularly from the viewpoint of political economy, the outstanding driving force behind the initiative of Southern Cone countries to engage in discriminatory regional trade arrangements could have also been a different one. After several decades of protectionism and extremely inward-oriented policies, among which forced import substitution played a prominent role, many Latin American countries realised that their development strategy had neither brought them higher levels of per capita income nor higher and sustainable rates of economic growth. The belief that import substitution and the protection of infant industries could constitute welfare-increasing instruments to help Latin American countries develop a dynamic comparative advantage in manufactures and thereby improve their terms of trade, which were largely determined by primary commodity exports, had to be given up. In the wake of the debt crisis of 1982, a major external shock for most Latin American countries (including Chile), many countries of the region revised misconceived policy attitudes and used the so-called lost decade (the 1980s) as an opportunity to carry out (or at least to prepare for) fundamental economic reforms. Internal and external macroeconomic equilibrium had to be restored, and favourable conditions had to be created for economic growth to resume (Williamson 1990). In retrospect, thus, in the end, the "lost" decade was not so lost after all.



It might possibly be too early to conclude from this that the transformation of Latin America has already been accomplished. The picture today still is somewhat mixed. While Venezuela, for example, appears to have chosen to restore the ancien régime (Williamson 1995) instead of coping with the consequences of what has been called the "Dutch disease", economic reforms in other countries, particularly in the MERCOSUR member countries, have been acknowledged to be clearly underway, even if they are still far from catching up with Chile, a country that embarked upon a course of market-oriented reforms as early as 1973 (Edwards 1995). Regional integration fits into the overall economic reform framework by representing a radical shift in trade policy. A country that decides to join neighbour countries in setting up a preferential trade scheme like MERCOSUR demonstrates that its policy makers hold a view of trade liberalisation and foreign competition that radically departs from the protectionist views held in the past to justify inward-looking policies. Thus, the failure of excessively inward-oriented policies and the serious economic and social consequences of this failure could be hypothesised to constitute the main reason behind the recent shift in economic policy in Latin America. In contrast to Baldwin (1995), who points at an exogenous influence, in this paper we argue that the major force driving regional integration is an endogenous change in fundamental attitudes experienced in Latin America.

Why did regional integration in Latin America never work before? The answer to this question is closely related to the decision to stick to inward-oriented policies for many decades. But let us first review some of the empirical evidence. The empirical literature on economic integration generally focuses on the performance of the European Community and, more recently, of the North American Free Trade Association (NAFTA)<sup>2</sup>; thorough empirical investigations of Latin American integration initiatives are very rare. Hitherto published analyses of the impact of membership in LAFTA and the Latin America Integration Area (LAIA) on Argentina and Brazil (Foders 1987), of the impact of membership in the Caribbean Common Market (CARICOM) on Jamaica (Foders 1987) as well as of the impact of the Andean Pact on Bolivia, Colombia, Ecuador, Peru and Venezuela (Foders 1990) revealed an excess of trade diversion over trade creation (static effects) and almost negligible dynamic effects of integration (impact of regional integration on growth and income). Obviously, this is not a representative survey of the literature. It is, nevertheless, interesting that in all cases studied the main reason for the failure of regional

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<sup>2</sup> See, for example, the Editorial Note by Greenaway (1992) in the *Economic Journal* and the papers by Sapir on Europe and by Brown, Deardorff and Stern on North America in that journal's issue. In a recent book, Senii (1996) presents a comprehensive analysis of NAFTA.

integration in Latin America was the inability of the member countries to comply with the agreed liberalisation of intra-regional trade, i. e., to liberalise their own trade regime vis-à-vis other members. Trade liberalisation was simply totally incompatible with traditional inward-looking policies. The indication is, thus, that the decisive test for any new Latin American initiative aiming at regional integration will entail the willingness of the member countries to dismantle tariffs and nontariff barriers.

### III. MERCOSUR: The Facts so Far

The Treaty of Asunción (30 I.L.M. 1041 (1991) and 34 I.L.M. 1244 (1995)) foresees the establishment of a common market by 31 December 1994. Put in simple terms, the common market is stipulated in the Treaty to be achieved through a reduction of tariffs and nontariff barriers, the introduction of a common external tariff, the co-ordination of trade policy vis-à-vis third countries, the co-ordination of macroeconomic and sectoral policies among the member states, and the approximation of national laws of member states. As such the Treaty of Asunción aims at deepening the economic relations between the member states to an extent which goes unmatched by any other Latin American integration initiative, perhaps with the exception of the Andean Pact.

The short history of MERCOSUR makes it rather difficult to analyse empirically its performance so far. It is possible, however, to scrutinise the period preceding the formal initiation of MERCOSUR. The rationale for this procedure is that there were several institutional precursors to the Treaty of Asunción: bilateral trade agreements were signed first by Argentina and Uruguay as early as 1974 (Convenio Argentino - Uruguayo de Cooperación Económica (CAUCE)) and then, in 1975, by Brazil and Uruguay (Protocolo de Expansión Económica (PEC)). In 1986 Argentina and Brazil signed a treaty on cooperation in trade and in a number of economic sectors (Programa de Integración y Cooperación Económica Argentina - Brasil (PICAB)), which constitutes a sub-regional initiative within the Latin American Integration Association of 1980 and which is open to other LAIA member states. Uruguay and Paraguay joined the PICAB in 1988 and 1990, respectively. Finally, Argentina and Brazil signed an additional treaty summarising all prior agreements in 1990 (Acuerdo de Complementación Económica (ACE Nr. 14)).

A glance at the development over time of import shares in the member states in the period 1975 - 1994 (Tables 1 - 4) reveals that

- Argentina's, Brazil's and Uruguay's share of total imports originating in MERCOSUR countries has been increasing; Paraguay experienced an increase from 1975 to 1985 and a decline thereafter, and that

**Table 1: Argentina: Impact of MERCOSUR on Imports 1975 - 1994 (per cent)**

from	Imports				
	1975	1980	1985	1990	1994
World	100	100	100	100	100
Brazil	9	10	16	18	19
Paraguay	1	1	1	1	1
Uruguay	1	1	2	3	4
MERCOSUR	11	12	19	22	23
Third Countries	89	88	81	78	77

\* less than 1 per cent

Source: IMF, Direction of Trade, various issues; - own calculations.

**Table 2: Brazil: Impact of MERCOSUR on Imports 1975 - 1994 (per cent)**

from	Imports				
	1975	1980	1985	1990	1994
World	100	100	100	100	100
Argentina	2	3	3	7	11
Paraguay	1	1	1	1	1
Uruguay	1	1	1	3	1
MERCOSUR	2	4	5	11	13
Third Countries	98	96	95	89	87

\* less than 1 per cent

Source: IMF, Direction of Trade, various issues; - own calculations.

**Table 3: Paraguay: Impact of MERCOSUR on Imports 1975 - 1994 (per cent)**

from	Imports				
	1975	1980	1985	1990	1994
World	100	100	100	100	100
Argentina	19	20	17	12	15
Brazil	21	27	36	17	12
Uruguay	2	3	1	1	1
MERCOSUR	42	50	54	30	28
Third Countries	58	50	46	70	72

Source: IMF, Direction of Trade, various issues; - own calculations.

**Table 4: Uruguay: Impact of MERCOSUR on Imports 1975 - 1994 (per cent)**

from	Imports				
	1975	1980	1985	1990	1994
World	100	100	100	100	100
Brazil	8	11	12	17	24
Paraguay	13	17	18	23	26
Uruguay	1	1	1	1	*
MERCOSUR	22	29	31	41	50
Third Countries	78	71	69	59	50

\* less than 1 per cent

Source: IMF, Direction of Trade, various issues; - own calculations.

- the importance of MERCOSUR as a source of imports decreases as country size increases: Uruguay and Paraguay are much more dependent on MERCOSUR for their imports than Argentina and Brazil. For the latter, MERCOSUR will hardly ever provide more than 20-30 per cent of imports.

To a certain extent, thus, this picture seems to imply that the Treaty of Asunción formalised natural trade flows that can be always expected to occur between neighbouring countries. In this context it would be appropriate to invoke economic theory in form of the well-known gravity models to explain trade between countries having common borders. These models attribute increases in trade to transport cost savings accruing to adjacent countries by substituting supplies from third countries by supplies from bordering countries. An increase in trade intensity between MERCOSUR countries since the mid-1980s has been found in a study by Amjadi, Winters and Yeats (1995), who present estimates of transport costs in Latin America derived from gravity models. Their research seems to support the trade developments implied by simple import shares (see above).

While the behaviour of import shares and transport costs could be taken to indicate the existence of a strong and growing economic link between these countries, using ex post estimates of income elasticities of import demand (following the lead of Balassa (1967)), it turns out to be rather difficult to detect either trade creation or trade diversion in the period 1975 - 1994, i. e. before the establishment of MERCOSUR (Table 5). This could be a consequence of the high instability of growth and trade experienced by the MERCOSUR countries in the last two decades. In a sense, it points at the limitations of inferences made on the basis of income elasticities in an volatile macroeconomic environment.

In order to get an idea of the future potential of trade between MERCOSUR member states, it should be useful to determine the individual trade specialisation of these countries. Table 7 shows estimates of the index of technological specialisation (the well-known index of revealed comparative advantage (RCA) calculated on the basis of a grouping of traded goods according to their technology content (Table 6)).<sup>3</sup> The estimates presented in Table 7 show that MERCOSUR member countries are specialised in goods embodying standard technology. The international position of MERCOSUR countries with respect to their technological and trade specialisation can be seen from Figure 1; it turns out to be similar to Greece's and Portugal's. Trade in

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<sup>3</sup> The reason for the new name of the index is that it is used in this paper exclusively to determine international trade specialisation in certain goods and not to study comparative advantage. On this see Fodors (1995).

**Table 5: Income Elasticities of Import Demand<sup>a</sup> of MERCOSUR Member States**

Countries /Origin of Imports	1975-1980	1980-1985	1985-1990	1990-1994
Argentina	2.30 <sup>b</sup>	-1.99 <sup>b</sup>	0.37 <sup>b</sup>	7.75 <sup>b</sup>
from World	12.01	8.50	7.84	4.12
from Brazil	13.17	4.47	12.92	5.10
from Paraguay	9.19	8.93	74.41	-1.14
from Uruguay	24.99	6.80	38.62	4.96
from Third Countries	11.96	9.03	6.05	3.97
Brazil	7.23 <sup>b</sup>	1.38 <sup>b</sup>	1.91 <sup>b</sup>	2.37 <sup>b</sup>
from World	1.90	-7.46	5.24	-4.17
from Argentina	4.53	-4.70	15.63	1.89
from Paraguay	4.18	17.97	33.44	-9.32
from Uruguay	3.54	-4.60	22.22	-10.15
from Third Countries	1.85	-7.54	4.50	-4.49
Paraguay	10.42 <sup>b</sup>	2.36 <sup>b</sup>	3.92 <sup>b</sup>	2.88 <sup>b</sup>
from World	2.38	-1.05	7.07	3.56
from Argentina	2.62	-2.62	6.38	6.27
from Brazil	3.33	1.50	1.50	2.72
from Uruguay	3.63	-5.62	3.79	1.99
from Third Countries	2.02	-1.56	9.67	5.75
Uruguay	4.52 <sup>b</sup>	-2.59 <sup>b</sup>	3.79 <sup>b</sup>	4.68 <sup>b</sup>
from World	5.85	4.75	3.64	-0.98
from Argentina	8.31	-3.68	5.65	1.31
from Brazil	8.56	-0.96	5.75	-0.20
from Paraguay	11.55	-1.02	3.85	-7.33
from Third Countries	5.31	5.27	2.78	-1.86

<sup>a</sup> average annual rate of growth of real imports divided by the average annual rate of growth of real gross domestic product. GDP has been deflated using the IMF's GDP deflator (1990 = 100) and imports have been deflated using the wholesale price index of the United States (1990 = 100).

<sup>b</sup> average annual rate of growth of real gross domestic product (in per cent).

Source: GDP: IMF, International Financial Statistics, Online Data Bank; - Imports: IMF, Direction of Trade, Online Data Bank; - Own calculations.

**Table 6: Technology Content of Traded Goods by SITC (Rev. 3) Headings and Code Numbers**

Code Number	Heading <sup>a</sup>
<b>1. High Technology</b>	
54	Pharmaceutical products
72	Machinery specialized for part. industries
74	General industrial machinery and equipment
75	Computer and other office machines
764	Telecommunications equipment
772	Electronic components (excl. semiconductors)
774	Medical apparatus
776	Semiconductors, etc.
778	Electrical machinery and apparatus
792	Aircraft and associated equipment, spacecraft, etc.
793	Ships, boats and floating structures
87	Professional, scientific and controlling instruments
88	Photographic and optical apparatus and equipment
<b>2. Intermediate Technology</b>	
3	Mineral fuels, lubricants and related materials
5 (less 54)	Chemicals and related products
61	Leather, leather manufactures
62	Rubber manufactures
64	Paper, paperboard and articles of paper pulp
71	Power generating machinery and equipment
73	Metal working machinery
76 (less 764)	Sound recording equipment
77 (less 772, 774, 776, 778)	Household appliances, transformers, etc.
78	Road vehicles
<b>3. Standard Technology</b>	
0	Food and live animals
1	Beverages and tobacco
2	Crude materials, inedible, except fuels
4	Animal and vegetable oils, fats and waxes
63	Cork and wood manufactures
65	Textile yarn, fabrics
66	Non-metallic mineral manufactures
67	Iron and steel
68	Non-ferrous metals
69	Manufactures of metals
79 (less 792, 793)	Other transport equipment
81	Prefabricated buildings etc.
82	Furniture etc.
83	Travel goods, handbags etc.
84	Articles of apparel and clothing etc.
85	Footwear
89	Miscellaneous manuf. articles
9	Commodities and transactions not classified elsewhere

<sup>a</sup> Abbreviated; wording occasionally deviates from the official source.

Source: Fodors (1995), Table A1, p. 25.

**Table 7: International Technological Specialization\* of MERCOSUR Member States, 1980, 1985, 1992 and 1993**

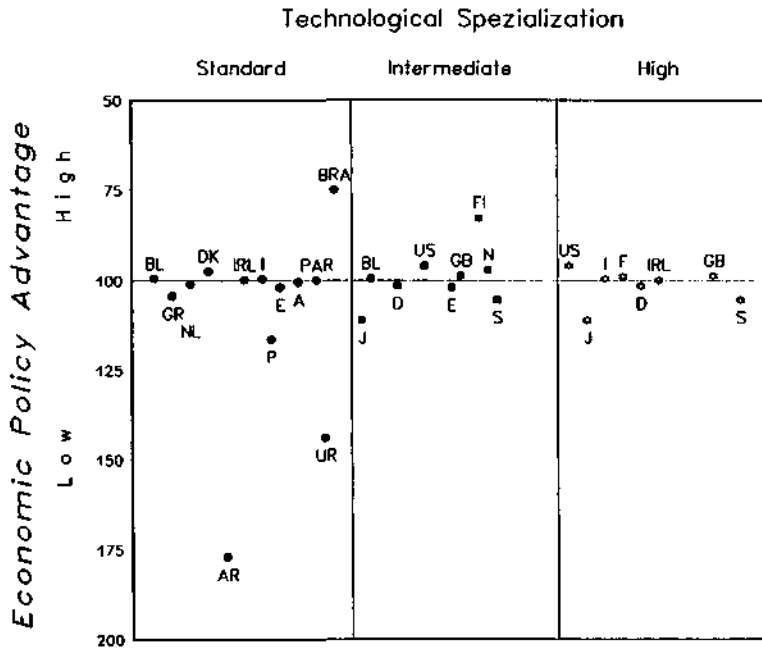
Technology Content of Traded Goods	Argentina	Brazil	Paraguay	Uruguay
<b>1980</b>				
Standard Technology	1.14	1.13	1.02	1.32
Intermediate Technology	-0.67	-1.39	-1.82	-1.29
High Technology	-2.58	-2.22	-6.85	-4.20
<b>1985</b>				
Standard Technology	1.27	1.15	1.05	1.19
Intermediate Technology	-0.64	-0.64	-1.79	-1.33
High Technology	-2.56	-2.17	-5.25	-4.03
<b>1992</b>				
Standard Technology	1.36	1.49	1.00	1.32
Intermediate Technology	-0.85	-0.89	-0.55	-1.29
High Technology	-2.59	-1.89	-4.63	-3.40
<b>1993</b>				
Standard Technology	1.42	1.48	1.09	1.31
Intermediate Technology	-0.98	-0.85	-0.92	-1.33
High Technology	-2.22	-1.88	-5.14	-3.13
* As measured by the Index of Technological Specialization.				

Source: Own calculations with OECD trade data.



Figure 1 -

## *International Position of MERCOSUR Countries 1992*



Source: MERCOSUR: Own estimates; European Union, USA, Japan: Fodors (1995).

standardised goods generally takes place in competitive markets and is largely based on cost, which, in turn, is influenced by macroeconomic policies. Countries benefiting from macroeconomic policies enhancing cost advantage should constitute attractive locations for firms engaged in the production of goods incorporating standard technology (largely labour and natural resource intensive goods). As concerns MERCOSUR member countries's macroeconomic policy advantage, as measured by the real effective exchange rate in 1992, Brazil and Paraguay were in a relatively favourable position whereas Argentina and Uruguay were not.

The index of technological specialisation allows to identify the specific traded goods subgroups in which the MERCOSUR member states are specialised (Table 8). It can be seen that in many cases the subgroups overlap, which means that there is great potential for intra-industry trade in differentiated goods among member states. Since not all the goods overlap, there also is a potential for inter-industry trade. While the potential for intra-industry trade does not necessarily call for substantial resource reallocation, the potential for inter-industry trade does indicate that in some member countries resources will have to move from import-competing to export-oriented industries as a result of the new regional division of labour which is likely to emerge in the wake of trade liberalisation and regional economic integration.

In 1993, tradables with an intra-industry trade potential were: foodstuffs, beverages and tobacco, crude materials, inedible (except fuels), animal and vegetable oils, fats and waxes, leather and leather manufactures, textile yarn, fabrics, iron and steel, non-ferrous metals, prefabricated buildings, furniture, travel goods, handbags, articles of apparel and clothing and footwear (Table 8). Since, to a large extent, the borderline between tradables and nontradables is determined by macroeconomic and trade policy, further opportunities for intra-industry trade could arise from turning goods which belonged in the past to the group of nontradables into tradables like, for example, automobiles and machinery.

One of the objectives of MERCOSUR is to co-ordinate macroeconomic policies among the member states. As can be seen from Table 9, this is one of the areas of public policy in which major efforts will be necessary. In spite of the fact that growth resumed in all member states in the 1990s, large cross-country differentials still exist in the size of the budget deficit, in the rate of inflation and in the size of the current account deficit. This reflects national difficulties in managing government expenditure, increasing tax revenue, mobilising domestic private savings and maintaining a stable

**Table 8: MERCOSUR Member States: International Technological Specialization<sup>a</sup> by SITC Subgroups<sup>b</sup>, 1993**

Country	Technology Content of Traded Goods	No. of Subgroups
	<b>High Technology<sup>c</sup></b>	
Argentina	-	-
Brazil	-	-
Paraguay	-	-
Uruguay	-	-
	<b>Intermediate Technology<sup>c</sup></b>	
Argentina	3, 61	2
Brazil	61, 62, 76 (less 764)	3
Paraguay	61	1
Uruguay	61	1
	<b>Standard Technology<sup>c</sup></b>	
Argentina	0, 1, 2, 4, 67, 68, 83, 85	8
Brazil	0, 1, 2, 4, 63, 65, 66, 67, 68, 81, 82, 83, 84, 85	14
Paraguay	0, 2, 4, 63, 82, 83, 84	7
Uruguay	0, 2, 65, 66, 81, 83, 84, 85	8

<sup>a</sup> as measured by the Index of Technological Specialization;  
<sup>b</sup> only the SITC code number of those subgroups is reported here, in which the corresponding country shows an Index of Technological Specialization > 0;  
<sup>c</sup> the total number of subgroups is 13 (high), 10 (intermediate) and 18 (standard).

Source: Own calculations with OECD data.

**Table 9: MERCOSUR Member States: Selected Macroeconomic Indicators**

	1980-1985	1985-1990	1990-1995 <sup>a</sup>	
	<b>Growth of Real GDP<sup>b</sup></b>			
Argentina	-1.99	0.37	5.70	
Brazil	1.38	1.91	2.91	
Paraguay	2.36	3.92	3.10	
Uruguay	-2.59	3.79	4.14	
	<b>Rate of Inflation<sup>b</sup></b>			
Argentina	382.38	1191.64	42.60	
Brazil	153.88	1056.40	1257.90	
Paraguay	15.94	28.14	17.76	
Uruguay	45.94	79.02	60.94	
	1980	1985	1990	1994
	<b>Current Account Balance<sup>c</sup></b>			
Argentina	-2.3	-1.1	3.2	-3.9
Brazil	-5.5	-0.1	-0.9	-0.2
Paraguay	-6.2	-5.5	-3.3	-8.8 <sup>d</sup>
Uruguay	-7.0	-2.1	2.2	-1.7 <sup>d</sup>
	<b>Government Budget Balance<sup>c</sup></b>			
Argentina	-2.60	-5.51	0.0	-0.5
Brazil	-2.41	-11.12	-5.66	-4.5
Paraguay	0.32	-0.50	2.93	2.0
Uruguay	0.03	-2.43	0.37	-2.9

<sup>a</sup> 1995: own estimate;  
<sup>b</sup> average annual rate in per cent;  
<sup>c</sup> as per cent of GDP;  
<sup>d</sup> 1993.

Source: IMF, International Financial Statistics, Yearbook 1995 and January 1996; - Own calculations and estimates.

**Table 10: MERCOSUR Member States: Foreign Debt Position 1993 (per cent)**

Country	Total External Debt as per cent of		Total Debt services as per cent of Exports	Interest Payments
	GNP	Exports		
Argentina	28.6	417.3	46.0	25.3
Brazil	26.3	296.0	24.4	9.2
Paraguay	20.4	73.0	14.9	4.6
Uruguay	54.3	243.7	27.7	16.5

Source: World Bank, World Development Report 1995, Table 23, pp. 206 - 207.

real exchange rate.<sup>4</sup> Also, member states differ in the foreign debt burden they have to carry (Table 10).

#### IV. Conclusions

The Treaty of Asunción offers Argentina, Brazil, Paraguay and Uruguay the opportunity to dismantle the high level of tariffs and nontariff barriers introduced over several decades in which the inward-looking approach dominated economic policy in these countries. It is of course too early to carry out a thorough assessment of integration; MERCOSUR has been stipulated to begin only on 1 January 1995. Nevertheless, the analysis of simple import shares clearly reveals a tendency for member countries to resort increasingly to suppliers in the member states, which from the point of view of the gravity model of international trade seems to reflect transport cost savings. It is of course debatable whether this kind of trade should be considered to be trade diversion.

Estimates of ex post income elasticities of import demand fail to show strong trade links between the member states in the period before integration officially commenced. This result seems to reflect the high instability experienced by these countries in the period under study. As far as the future potential for trade between member states is concerned, estimates of the index of technological specialisation point toward a substantial potential for intra-industry trade and also toward a certain (through smaller) potential for inter-industry trade.

<sup>4</sup> On this, see, for example, Williamson (1995) and Edwards (1996).

For MERCOSUR to be called a "new approach to regional integration" several policy conditions will have to be met in the near future. First, member states will have to demonstrate a credible shift in trade policy from protectionism to trade liberalisation. Second, the attainment of lasting price stability will call for still further reforms of fiscal and monetary policy and for the establishment of a viable exchange rate regime. Third, South-South trade can only be a part of total foreign trade of MERCOSUR member states; imports of embodied and disembodied technology and know how, which will be necessary to achieve high and sustainable rates of economic growth, will continue to originate in the OECD countries. Therefore, trade liberalisation and other microeconomic reforms (privatisation, deregulation) should also aim at improving economic relations with third countries, which is tantamount to say that the "new approach to regional integration" should avoid becoming a "Fortress MERCOSUR" and from the outset include measures to foster integration of member states into the world economy.

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