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VENEZUELA'S ROAD FROM CAN TO MERCOSUR

An Explorative Study on Trade Effects and Specialization

by

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Abstract

Latin America has throughout the years been home for different regional integration agreements. The two most recent examples of South American integration blocs are the Andean Community of Nations (CAN) and *Mercado Común del Sur* (Mercosur). This thesis focuses on the static effects of integration which are caused by the future inclusion of Venezuela, a new member to Mercosur. Moreover, Venezuela's revealed comparative advantage and specialization in the fuel-sector are scrutinized, adding value to the analysis of trade effects of integration. The character of this study is explorative and forward-looking. It mainly aims at analyzing the *likely* outcomes of Venezuela's integration to Mercosur in terms of trade creation and trade diversion. To accomplish this, the author makes use of 'Viner's ambiguity' crystallized in five conditions. The results of the study indicate that trade diversion dominates in four out of five analyzed conditions. However, the effects cannot be quantified and therefore a conclusion on whether integration will lead to welfare gains or losses is not possible. Venezuela is South America's biggest oil-producing country. Hence, a thorough calculation on specialization using Balassa's revealed comparative advantage on the fuel sector has been carried out. The results indicate that the revealed comparative advantage is lower for Venezuela in relation to CAN. This may imply that Venezuela has a greater potential in specializing in the fuel sector in the future bloc, Mercosur.

Keywords: Venezuela, Mercosur, Andean Community of Nations (CAN), economic integration, static effects, trade diversion, trade creation, oil, specialization

Table of Contents

LIST OF ABBREVIATIONS

ALBA	Alianza Bolivariana para los Pueblos de Nuestra America
APEC	Asian Pacific Economic Cooperation
CAN	Comunidad Andina the Naciones (*Andean Community of Nations*)
CU	Customs union
EU	European Union
FTA	Free trade area
LAFTA	Latin American Free Trade Agreement
LAIA (ALADI)	Latin American Integration Association
MERCOSUR	Mercado Común del Sur (*Southern Common Market*)
NAFTA	North American Free Trade Agreement
NTB	Non-tariff barrier
OPEC	Organization of the Oil Producing Countries
PDVSA	Petróleos de Venezuela
RCA	Revealed comparative advantage
TB	Tariff barrier

LIST OF FIGURES

LIST OF TABLES

1. Introduction[*]

Throughout Latin American history many attempts have been made to construct regional trade blocks in order to increase welfare, stability and gain international bargaining power. However, most of these attempts were unsuccessful or at best exhibited with limited success. *Mercado Común del Sur* (Mercosur) is the latest form of economic integration in the region, consisting of the two South American giants, Brazil and Argentina, together with Uruguay and Paraguay. In 2006, Venezuela took first steps towards becoming the first new member country, outside of the original four, to join Mercosur. In order to become part of Mercosur a precondition for Venezuela was the withdrawal from the Andean Community of Nations (CAN). This implied that Venezuela's entry into Mercosur ran parallel with abandoning a smaller customs union.

Yet, the definitive entry into Mercosur has not been settled. Despite the country's application being approved by Argentina, Uruguay and Brazil, and even with the demission from CAN in 2006 there are still formal steps left together with Paraguay's acceptance.[1]

Venezuela's entry has been desired by most Mercosur members partly because of the country's rich oil endowments and the opening up of a large middle class market. In turn, Venezuela on the one hand has seen this integration process as a means to promote the alternative economic order from ALBA (Alianza Bolivariana para los Pueblos de Nuestra America) and gain political stability. On the other hand there are expectations to gain the economic advantages associated with integrating into a more powerful customs union.

The present study will discuss the likely trade effects of Venezuela's integration into Mercosur using two approaches on economic integration, primarily Viner's theory of trade-diversion and trade creation and Balassa's specialization index. The understanding of these effects of integrating one country to Mercosur can help analyze the effects of other countries planning to make the same or similar shifts.

[1] Mercopress (2009)

1.1 Statement of purpose

The aim of this study is to evaluate the likely economic and specialization effects of Venezuela's future entry into Mercosur. It concentrates on the likely trade and specialization effects of a shift from CAN to Mercosur and attempts to answer whether trade creation or trade diversion will dominate thus predicting the welfare effects of integration. The analysis of trade creation and trade diversion effects are of a preliminary and forward-looking nature, considering that Venezuela has not yet completely joined Mercosur. Due to the pivotal importance of oil for the Venezuelan economy, the author aims to analyze whether specialization will continue to be in the fuel-sector.

1.2 Disposition

The study is divided into seven chapters. In order to provide the background information necessary, it will start by presenting the theoretical background with an overview of the theories of economic integration. The main focus lies on the static effects of integration. Chapter three presents a short historical overview on the integration process in Latin America in order to give the reader a basic understanding of the South American integration developments. Moreover, a section on the development of the Andean Community of Nations and Mercosur will be presented in order to indicate the historical and structural differences between them. Both blocs are presented because of their importance for Venezuela and its economy. Chapter four presents background information on Venezuela, its economy and trade patterns. Chapter five focuses on the shift from CAN to Mercosur and the Venezuelan trade relations with both blocs. Chapter six assesses the likely trade creation and trade diversion effects of integration in order to answer which the likely trade diversion and trade creation effects of a future integration will be. The analysis will be based on the seven assumptions made in chapter two. In chapter seven a shorter analysis on specialization will be conducted. This chapter will focus on whether it is beneficial for Venezuela to specialize in oil after having entered Mercosur. Finally the study ends up with a summary and conclusions.

2. Theory of Economic Integration

This chapter provides the relevant theoretical background of economic integration with emphasis on trade diversion and trade creation. [2] It presents 'Viner's ambiguity', a set of conditions which are likely to affect the size of trade creation and trade diversion while leading to welfare gains or welfare losses respectively. These conditions are of importance because of Venezuela's current uncertain situation related to the entry to Mercosur: As it is not a complete member of the trade bloc, an analysis of the current effects of integration is yet not possible.

2.1 Economic integration

Economic integration of countries can be seen as the removal of internal barriers for both products and factors of production. States within the area of integration will remove tariff-barriers between them, while retaining trade barriers with third countries. On a basic theoretical level, integration can be divided into two forms, positive and negative integration. [3] Negative integration is the simplest form of integration. It only concerns the removal of tariffs and other trade barriers while positive integration is the deeper type of integration, implying the creation of common policies and institutions. The European Union (EU) is a paradigmatic example of positive integration with its large spectrum of common institutions and policies. Mercosur is more likely to be positioned on the 'negative integration side' as it is still lacking supranational institutions and policies which characterize positive integration.

In general, regional integration areas can be seen as tools to facilitate trade between countries and minimize the effects of barriers on trade. [4] Over the past decades integration has increased in importance. Today, one third of total world trade takes place within regional trade agreements. Balassa provides a suitable tool to classify stages of economic integration. [5] On a

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[2] This chapter draws mainly on Nello (2009), p.76-109,110-131 unless it is indicated otherwise.
[3] In reality, this distinction is not clear-cut as negative and positive integration is often overlapping (Pelkmaans 2006, p.7). Moreover, there is still an ongoing academic debate as to the implications of both negative and positive integration (cf. Scharpf 1996).
[4] The conditions for these free trade areas are set by GATT's article XXIV.
[5] Nello (2009), p. 5

basic level there are three four stages.[6] They can take the form of 1) Free Trade Areas (FTAs), 2) Customs Unions (CUs), 3) common markets and 4) monetary unions[7] and have a set of both dynamic and static effects (which will be covered in section 2.2).

2.1.2 Free Trade Area

The FTA is the simplest stage of integration.[8] It implies free trade between member states while the different trade policies towards third countries remain unchanged. Examples are The North American Free Trade Agreement (NAFTA), a FTA between countries, however a FTA can also exist between countries and trade blocs like Mercosur's FTA with Bolivia and Chile.[9] In order to implement a FTA, common supra-national institutions like those which are present within the EU are not necessary. However a FTA also poses a problem for the countries forming a part of them, that is, the issue of trade deflection towards other member countries.[10] Trade deflection occurs when one member country with a lower import duty on a certain product can re-export it towards the other member countries with higher duties on the same good.[11] This issue can be solved through the use of rules of origin which prove the origin of the product; however if the rules of origin are not clear enough they can be misused.

2.1.3 Customs Union

A CU is a slightly more advanced stage of economic integration. It goes a step further towards integration by adding a common external tariff towards the rest of the world while preserving free trade within the customs union. Furthermore, a CU also implies agreeing upon a common tariff, which should not be higher than before integration, and the coordination of tariff-revenues.[12] In CUs trade deflection is not an issue because of the common tariff applied by all member countries. Mercosur and CAN are both examples of customs unions. However, there are still many non-tariff barriers (NTBs) and some tariff barriers (TB) present in these two schemes.

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[6] World Bank (2000), p.1
[7] An overlapping of these stages may also appear
[8] Nello (2009), p.5
[9] Shiff & Winters (2003), p. 198
[10] World Bank (2000), p.75
[11] ibid, p. 75
[12] ibid, p. 74-75

Finally there are two rather advanced forms of economic integration, the common market and the economic and monetary union. A common market does not only allow for free movement of products but also for free movement of labor, services and capital. The intention of Mercosur is to reach this stage of integration, however there have not yet been any bigger political steps towards this goal.[13] The economic and monetary union includes a common market and the creation of common policies in the field of for example monetary policy.

2.2 Static Effects

Static effects of integration are effects of resource allocation which take place at one particular time.[14] Jacob Viner introduced the concepts of trade creation and trade diversion as the static effects of integration on welfare. [15] These two concepts will be used throughout the analysis to explain the effects of Venezuela's integration into Mercosur (see chapter 6).

2.2.1 Trade Creation and Trade Diversion

Trade creation means the change from a relatively more expensive domestic production to a relatively cheaper foreign production from a partner country.[16] It occurs when the removal of tariffs incites a country to change its trade patterns so that the home country, which is less effective in production than the partner country, now can import the same good from the more efficient partner country. The positive effect of lower prices will lead to an increase of welfare effects in the importing country.

Trade diversion, on the other hand, means that imports from a more effective partner (outside the customs union) are substituted with imports from a less efficient partner (inside the customs union) since the removal of duties make the imports from other less efficient member countries cheaper.[17] The effect that trade diversion will have on a regional trade agreement is negative since it lowers the exports from the rest of the world.[18] Trade diversion can also lead to lower consumption prices, as in the trade creation case, whenever the changes in tariffs are significant enough to lower the consumption prices. However, the negative effects of trade diversion generally lower the welfare in a country through diminishing effectiveness. Yet,

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[13] Leipziger, et al (1997), p. 588
[14] Nello (2009), p.110-131
[15] World Bank (2000), p.39
[16] Senior Nello (2009), p.111
[17] ibid, p. 112
[18] Shiff & Winters (2003), p. 213

they cannot exceed the size of the country's external tariff.[19] It can be difficult, however, to determine whether a certain effect is the result of trade creation or trade diversion.[20]

The following figure (figure 2.1) demonstrates the trade diversion and trade creation effects of a customs union taking into account following six assumptions.

- The CU is made up by two countries, country A and B.

- The two countries are relatively small in the sense that they are unable to affect the world price.

- Before integration the tariff imposed by country B increases the domestic price to P_h.

- The formation of the CU removes all tariffs between the member countries.

- Country A has higher production costs in the specific industry measured.

- Country B is self sufficient in the specific industry measured meaning that trade in that sector does not need to be protected.

Figure 2.1 Trade Creation and Trade Diversion

Explanation of factors
P_{CU}: Price towards third countries (including the common tariff)
P_W: World price
P_p: Price in country A before trade creation
D_p: Demand in country A
S_p: Supply in country A
D_h: Demand in country B
S_h: Supply in country B
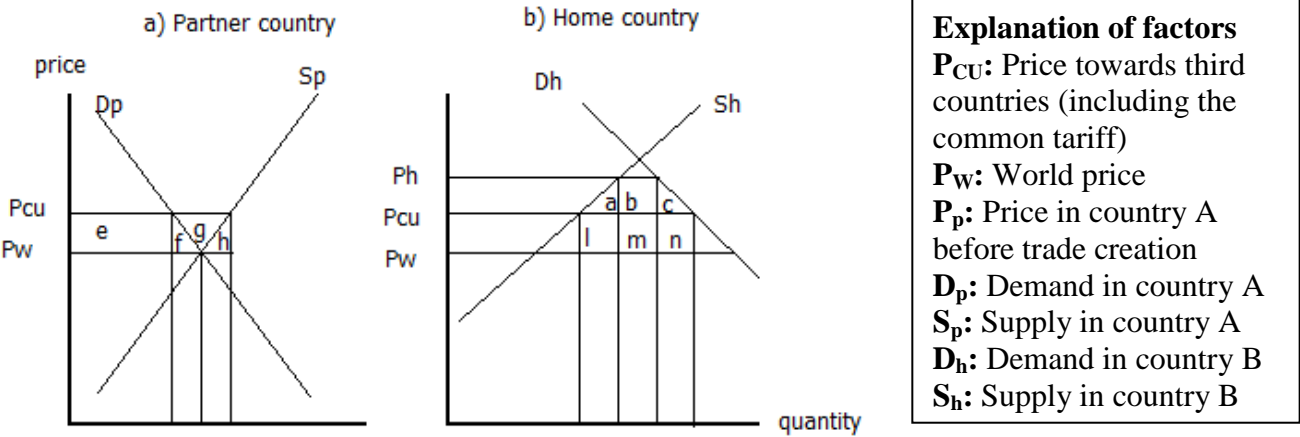
Source: Nello (2009), p.114.

[19] Shiff & Winters (2003), p. 34
[20] ibid, p. 14

If there are two countries joining a customs union and trade creation is the dominant effect, the combined net-effect of the country effect and the world effect, must be positive. Either one or both countries will benefit. However the third country, or the rest of the world, will not benefit from the positive effects in the short run because they lose exports which are taken over by the partner country.[21]

The price on imports will experience a decrease for country B which will lead to trade creation, thus to a welfare gain represented by triangle *a* on the production side and to triangle *c* on the consumption side. Trade diversion effects will on the other hand lead to a decrease in welfare by the size of rectangle *m.* In this case, if rectangle *m* is larger than the two trade creation triangles (a and c), trade diversion can be said to be larger than trade creation. For the partner country the situation is different. The country is more dependent on imports because of its high production costs. Due to the creation of the CU, prices will decrease the consumption surplus by *e* and *f* and increase home country's producer surplus with e, f and g which leaves a net welfare gain of g ((e+f)-(e+f-g)=g).

2.2.3 Static effects of a customs union on a new member

The elimination of barriers that occurs during the creation of a CU should lead to welfare gains through a better distribution of resources and through increased consumer surplus.[22] In the CU case, trade creation will occur when a formerly protected industry is obliged to compete with the rest of the member countries hence expanding trade to the other members as well. Competition leads to a redistribution of production, from a less efficient producer to a more efficient one, resulting in a lower price for the consumers and an increase in welfare.[23]

A CU or a single country dominated by trade creation effects will end up with a gain in welfare whereas if dominated by the trade diversion effects, the net effect on welfare will be negative. It is however difficult to estimate the effects of a CU before it has been formed. [24] Some predictive studies about, for example, the European market have been criticized due to under- and overestimation of the trade diversion and trade creation.[25] The later analysis (see

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[21] Nello (2009), p. 115
[22] Krueger (2009), p.188
[23] Nello (2009), p.118
[24] Balassa B (1967), p. 1-21
[25] ibid, p. 1-21

ch. 6) will therefore not attempt to quantify the effects of trade diversion and trade creation. It will only determine whether trade creation or trade diversion dominates according to the Vinerian conditions.

Jacob Viner proposed a model to make an ex-ante analysis of the effects of trade creation and trade diversion when joining a customs union.[26] The 'Vinerian ambiguity' consists of a set of conditions (interconnected to a set of variables) which increase welfare. Depending on the various conditions, predictions can be made on the welfare effects that integrating into a customs union will have on the home country. Importantly, these effects can be positive, negative or zero. The welfare effects depending on the following seven conditions are considered at a certain moment in time and keeping all other variables the same. This set of conditions will be used in chapter 6 to analyze whether trade creation or trade diversion effects dominate and hence leading to either positive or negative welfare effects.

1. *The size of the common external tariffs towards the third countries*. Tariff size before integration is important for the reduction of trade diversion effects. Hence, the condition is: the higher the external tariffs were before integration the lower the trade diversion effects will be. In other words, the lower the tariffs are set after integration, the lower will the trade diversion effects be. This certainly stems from the basic theory of trade diversion and trade creation. High tariffs towards the rest of the world provide an incentive to import from a less efficient partner country. The imports from this less efficient partner country are cheaper because of the high external tariffs which raise the price of the efficient partner outside of the CU. Moreover, this condition is inter-linked with the next condition.

2. *The size of tariffs within the integration area before integration*. The greater the tariffs were before integration, the greater will the impact on trade be and the greater will the trade creation effects be. Integrating into a CU implies the elimination of tariffs within the integration, as can be seen on figure 2.1. Trade diversion effects will be greater, if rectangle m in the home country is larger than the two triangles (a and c, which represent welfare gains). However, the condition supposes a complete elimination of tariffs. If the elimination of tariffs only is

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[26] Nello (2009), p. 118

partial, the difference in levels of tariffs will count. Thus, the greater the difference in tariffs the larger the trade creation effects.

3. *The size of the customs union*: The size of the integration area (both in terms of geography and population)[27] has an impact on the trade creation/diversion effects. A larger regional integration area is meant to lead to more trade creation effects than trade diversion effects. The larger the integration area the more consumption possibilities and the larger the chance that the most efficient producer is located within the integration area.

4. *The trade volumes before integration.* The larger the trade volumes before integration the greater the effects of trade creation will be in comparison to the trade diversion effects. This can also imply that countries are already trading with each other because they are natural trading partners.

5. *The similarity in economic structures within the customs union.* The more similar the member countries are in terms of economic structure, the greater the trade creation effects will be in comparison to the trade diversion effects. This can lead to specialization, and thus, to trade creation.

6. *The difference in costs of production between the countries in the regional integration area and third countries.* The greater the differences in costs of production, the larger the trade creation effects will be. This condition is also linked to the differences in tariffs in the integration area. However, it may be more appropriate to use this condition when countries join a north-south[28] integration project since the difference in costs of production is larger than in north-north or south-south integration.

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[27] Taking into consideration the two arguments: greater consumption possibilities and most efficient producer being situated inside the integration area.

[28] North-south integration means integration between developing countries (or blocs) and developed countries (or blocs), south-south integration means integration between developing countries (or blocs) Shiff & Winters (2003), p. 73

7. *The geographic proximity of the countries*. The closer the countries are to each other, the smaller the effects of trade diversion. Firstly, because of lower transport costs. Secondly, because closer geographical location can be linked to the similarity in structures.[29]

The analysis part of this study (ch. 6) will be based on these Vinerian conditions. However, one of the issues of using this method in order to gain knowledge about trade creation and trade diversion effects is the estimation of the size of the different effects. On the one end, studies conducted by for example Verdoon and Janssen used the same method and it resulted in an overestimation of the trade creation effects.[30] On the other end, other studies have overestimated the trade diversion effects. Due to the predictive nature of this analysis a quantification of the static effects cannot be conducted in chapter 6. Yet, the focus of that chapter lies on the dominance of either trade creation or trade diversion in order to avoid the mentioned criticism. Furthermore, the experimental nature of the above mentioned conditions makes it difficult to apply to a complex environment as is the Venezuelan economy. It does, for example, only take into account the production side, while leaving the consumption side aside. Still, this procedure enables to draw conclusion on welfare effects caused by trade creation and trade diversion and is one of few theories which can be applied in an ex-ante manner

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[29] World Bank (2000), p. 51
[30] Balassa (1967), p. 1

3. Andean Community of Nations and Mercosur

For an easier understanding and as a source of comparison, the following chapter provides background information on three different subjects. Firstly, it starts with South American integration throughout history. This is of significance as integration failures in the past can be traced and put into perspective. Secondly, the chapter continues with a short section on CAN to which Venezuela used to be a member for more than three decades. This is a necessary step in order to draw conclusions on the decision to join Mercosur. Thirdly, the final segment discusses Mercosur in order to facilitate the reader's understanding of the functioning of this trade bloc.

3.1 South American Integration before Mercosur

South American integration is not a new phenomenon. In 1819, just after the liberation process from the Spanish empire had come to an end, Gran Colombia was formed. It constituted of the integration of four South American regions which today are Panamá, Colombia, Ecuador and Venezuela. Although it only lasted for some 10 years this idea of integration is still present today.[31]

More recent attempts to advance South American economic integration were made during the 1960s, with the LAFTA (Latin American Free trade Association) and the Andes Pact. Yet, this integration process failed once again in the 1980s just as it did over a century earlier, and a new attempt for integration was made: LAIA (Latin American Integration Association). The efforts made in favor of integration where only partly successful and did not last for long. Neither the failed LAFTA, being too inflexible and too protectionist, nor the LAIA being a more flexible alternative, were able to achieve the great success that was expected due to the (debt) crisis of the 80's that affected many Latin American economies.[32]

Re-democratization in Latin America played a big role in the integration process of the region. The democratic regimes which were emerging in Latin America after years of

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[31] Arierti (2006)
[32] Kaltenthaler & Mora (2002), p. 73

dictatorship were aiming for political, financial and socioeconomic stability. The common view during this period was that focusing on a free market would lead to international attention and thereby to more democracy.[33] On a political level, the countries received increased sympathy and recognition by outsiders. Economically, the increased trust in the regimes boosted foreign direct investments together with general economic support and led temporarily to a decrease in inflation. Despite relative stability and democracy, the region was still lacking competitive power. Attempts to be able to compete with the rest of the world would finally lead to the creation of CAN and Mercosur.[34]

3.2 Andean Community of Nations (CAN)

The Andean Community of Nations or *Comunidad Andina de Naciones* (CAN) is one of the oldest examples of Latin American integration but at the same time one of the less important and less well known free trade areas.[35]

In 1969 the Cartagena Agreement was signed and CAN was formed between the five initial Andean member countries: Chile, Colombia, Ecuador, Peru and Bolivia. Venezuela did not become a member until 1973 and in 1976 Chile resigned from its membership. The goal within CAN was to develop a customs union and a common market until 2005. It received help from the European Union to develop common institutions and great effort was put into actually implementing these institutions. However, the CAN countries faced political instability and social inequality which lead to a decline of investments both foreign and local.[36]

Similarly to the Mercosur-institutions, the CAN institutions are rather weak. Despite their resemblance to the EU-institutions, there are many imperfections in the CAN-institutional model. As will be seen later in the Mercosur-example, the supranational spirit of the institutions is almost non-existent which makes it difficult to transfer competences from the national to the supranational level.[37] The problems affecting South American integration are not only limited to the lack of supranational institutions. Difficulties in applying the complex

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[33] Kaltenthaler & Mora (2002), p.75
[34] Ibid, p. 80
[35] Mazurek (2005), p. 163
[36] ibid
[37] Ibid, p. 164

CAN-rules together with high transportation costs within the region affect integration negatively.

The integration process was partially stopped during the 2000s when restrictions to free trade were introduced to the Andean Community. Apart from these restrictions Venezuela's withdrawal from CAN led to further decreased power of the trade bloc. Instead, the country initiated the integration process with Mercosur in 2006. However Venezuela still retained the preferential trade agreements with CAN for five years. Recently, Bolivia has shown interest in following the same path as Venezuela, something which would leave CAN as an even less significant union.[38]

3.3 Mercosur

Mercosur[39] is today the fourth biggest trading bloc after the European Union, the NAFTA (North American Free trade agreement), and the APEC (Asian Pacific Economic Cooperation).[40] It is a CU consisting of Argentina, Brazil, Uruguay and Paraguay and with Venezuela as aspiring member. The following section presents the creation of the bloc, the bloc today and its importance from a regional and global perspective.

Through the Treaty of Buenos Aires, later on followed by the Treaty of Asuncion, signed in 1991, the common market between Argentina, Brazil, Paraguay and Uruguay was established. The treaty is the foundation of Mercosur and aims to

- Implement free trade between members thus eliminating all trade barriers (both tariff barriers and non-tariff barriers)
- Establish a common external tariff
- Coordinate the macroeconomic policies in the member countries. [41]

The structure of the common market area does not resemble the structure of the previous forms of Latin American integration. The Preto protocol signed in 1994 made Mercosur legal under international law but it did not establish any significant supranational institutions other than the commerce commission.[42] South America's most important regional integration area

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[38] Comunidad Andina (2010)
[39] Ministerio de Relaciones exteriores Brazil (2009)
[40] Klonsky J (2009)
[41] Leipziger et al (1997), p. 585
[42] Lorenzo N (2006), p. 4

is today still lacking important supranational institutions which could facilitate the coordination of decisions, create a common identity and deepen integration. [43]

Figure 3.1, illustrates the organs which compose Mercosur. However there are only two organs, the Common Market Council and the Common Market Group which have intergovernmental power. [44] Together with monitoring institutions, such as the advisory forum on Economic and Social matters and the joint Parliamentary Commission, the Mercosur institutions have little decision-making powers. These powers are (still) left to the national institutions.[45]

Figure 3.1: Mercosur organs
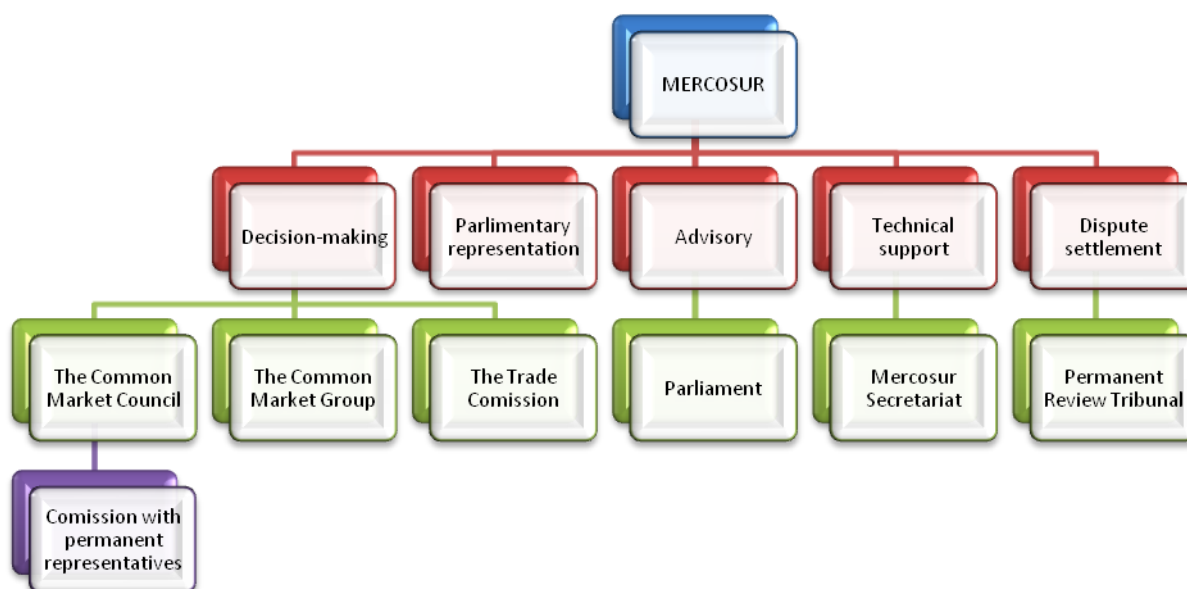
Figure based on information from Presidencia de Mercosur (2009)

The goals and objectives for Mercosur and the EU are fairly similar. However the early stage at which Mercosur is today has to be considered. It implies that most of the objectives are at a very early phase and under discussion[46] (practically not implemented) as are the following:

- Coordination policies in areas such as migration, safety and labor relations

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[43] Kaltenthaler & Mora (2002), p. 76
[44] Leipziger et al (1997), p. 588
[45] ibid, p.591
[46] ibid, p. 588

- Common norms for antidumping measures
- Establishment of an effective dispute settlement procedure

In practice, the lack of coordination could be one of the explanations to the limited impact on regional trade in comparison to the EU. Mercosur is also full of exceptions. It categorizes itself as a customs union on the way to become a common market. Currently, it resembles more a free trade area. Moreover, the development towards becoming a common market has almost stagnated.

3.3.1 Tariffs

The common external tariff of Mercosur has been subject to changes over time. A short time after the creation of Mercosur, a financial crisis struck the region, and Brazil and Argentina were facing severe economic problems which lead to an increase in tariffs.[47] Today, the common external tariff varies between 0% and 20%. Depending on the product, more value added products face higher tariffs.[48]

Due to the dialogue between Mercosur and CAN, economic integration in South America has made considerable steps forward. Despite the rule not to allow countries from other regional blocks to become a member of Mercosur, in 2004 the two South American trade entities signed economic complementation agreements. The agreements unite these two blocks into associated states thus promoting free trade in the region and allowing for individual CAN countries preferential trade agreements with Mercosur.[49] Moreover, CAN granted Mercosur countries preferential trade agreements to further improve integration.

The result from deepening integration between the two blocks has lead to lower tariffs between the two blocs. There are however many exceptions which vary from country to country depending on the main production of each country.[50]

3.3.2 Importance of Mercosur

Mercosur's importance in the region as the largest and most influential CU in South America is a source of attraction for other countries. There are indications that CAN-countries, like

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[47] Laens & Terra (2009), p. 82
[48] Mercosur (2009)
[49] Comunidad Andina (2004)
[50] Inter-Amercan Development Bank (2009b)

Ecuador and Bolivia, are likely to follow Venezuela's example and apply for membership to Mercosur.[51]

The size of the member countries' economies makes Mercosur an extraordinary potential market for other regional trade blocks as well as for individual countries. The two largest economies in South America, Argentina and Brazil are the two major members of this bloc. Together with Paraguay and Uruguay as full member states and Bolivia, Chile, Ecuador, Peru, Colombia and Venezuela as associated members, Mercosur covers 12 million km² which is almost 70% of the area of South American.[52] The area covered is especially important in South America because of its richness and variation in natural resources. The potential market is another significant factor. At present (2010), Mercosur (only including its four full members) has a GDP of over 2 trillion USD and a population of almost 250 million.[53]

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[51] Comunidad Andina (2010)
[52] CIA world factbook (2009a)
[53] WTO (2010a)

4. The Venezuelan economy and regional integration

Venezuela is the 5th largest economy in the region, the 5th largest oil producer in the world and the largest oil producer in the South American region. [54] The following chapter will provide a short presentation of the Venezuelan oil-based economy, its trade partners, trade volume and its role in Mercosur and CAN.

4.1 Venezuela's economy

The main resource in the Venezuelan economy has been, for over a century, oil. It was discovered in the 1900s and is still today playing a dominant role in the Venezuelan economy.[55] For a long time, the Venezuelan elite benefited from the oil-profits and during the 1970's the oil boom created immense wealth. Today the country's oil and natural gas reserves stand for 90% of the export earnings.[56] It is a very important factor for the Venezuelan economy and politics. [57] A recent example for this was the incidents that contributed to the oil strike of 2003 and finally led to a serious recession in Venezuelan economy.[58] The oil-richness of the country has left very little space for the other industries. Furthermore, the low development of the agricultural industry is a major point of distinction from the other Mercosur economies which mainly export agricultural products and non-mineral raw materials.

Under the left-wing rule of President Chávez, the changes in the Venezuelan economy have been radical and have affected many sectors, including the oil-sector. Through nationalization of many foreign owned oil-firms, *Petroleos de Venezuela* (PDVSA), the state-owned oil company has taken over many of the formerly foreign owned oil companies. This led to an increase in the government's revenue from the exploitation of natural resources. Table 4.1 demonstrates how private and public revenue differ from each other in the export sector before and after the major nationalizations. The public sector stands for a greater share of

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[54] CIA world Fact book (2009b)
[55] Economist Intelligence Unit (2009)
[56] CIA world Fact book (2009a)
[57] Alvarez & Hanson (2009)
[58] ibid

exports compared to before the crisis, its increased export share is mainly due to the acquisition of the formerly foreign-owned oil companies.

Table 4.1 Profits of exports in the private and public sectors

Exporting sector	Million USD 2008	% 2008	Million USD 2009	% 2009
Total	4.288	100,00	1.507	100,00
Private	2.707	63,10	731	48,50
Public	1.581	36,90	776	51,50

Computed data from: Instituto Nacional de Estadística Venezuela (2009a)

4.2 Structure of trade

The Venezuelan trade patterns consist, in general terms, of exports of natural resources and import of manufactured and agricultural goods. This results in difficulties in Venezuela's trade structure as its trade balance lied around -41 billion US $ in 2008.[59]

Venezuela's major trade partner on both the import and export side has for a long time been the United States (35.7%).[60] This trade being dominated by petroleum exports towards the US. Within South American boundaries, Venezuela trades mainly with its neighbor and former CAN-partner country Colombia (5.5%). Whereas trade with Brazil, the second biggest Latin American trade partner, is significantly lower (3.5%).[61] However, the decision to change from CAN to Mercosur together with the growing political tension between Colombia and Venezuela has already caused a decrease in the volume of trade with Colombia.[62]

4.2.1 The Oil-sector

Oil fuels the Venezuelan economy. The 'black gold' has for almost a century been responsible for 50% or more of the central government's revenue.[63] Together with the remaining fuel and gas industry it composes of 93.5% of the Venezuelan exports (to be compared with Brazil's 9.4%). As can be seen from table 4.2 the export of fuels differs significantly from the other member states.

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[59] Inter-American Development Bank (2009b)
[60] European Commission (2009)
[61] ibid
[62] Inter-American Development Bank (2009b)
[63] Economist Intelligence Unit (2009)

Table 4.2 Fuels share in economy's total merchandise export

	Value in million USD		Share in economy's total merchandise exports in percentage (%)	
Country/year	*2000*	*2008*	*2000*	*2008*
Venezuela	29203	67443	87.1	93.5
Argentina	4642	6717	17.6	9.5
Brazil	908	18689	1.6	9.4

Data from WTO (2009), p. 60

The large dependency on oil has lead to a form of Dutch Disease, with the overvaluation of the real exchange rate and the worsening of the competitiveness of the manufacturing industries.[64] The present policies are trying to diminish the dependency on energy-related exports through diversification of exports, increasing investments in agriculture and education as well as focusing on the accession of new markets.[65]

The entry to Mercosur opens up the frontiers and allows the country to access already existing markets at a lower tariff rate. On the one hand, energy-export, especially towards Brazil and Uruguay, could in the future mean a redirection of Venezuelan trade.[66] On the other hand, the tariff levels on fuels do not reach significant levels. Therefore, integration would have little effect on the fuel market.

4.2.2 The agricultural sector

The agricultural sector in Venezuela differs significantly from agricultural sectors of the other Mercosur countries. Venezuela is not a large producer of agricultural products like Brazil or Argentina and is dependent on agricultural imports from its neighboring countries. As mentioned before, policies are being implemented in order to enhance local agricultural production.[67] However, the entry into Mercosur would mean that the Venezuelan agricultural sector would have to adapt in order to be able to compete with agricultural imports from Argentina or Brazil.

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[64] Economist Intelligence Unit (2009)
[65] European Commission (2007)
[66] WTO (2010b)
[67] Alvarez & Hanson (2009)

Throughout the later part of Venezuelan history, agriculture has played a rather modest role in the Venezuelan economy. Agricultural products like fruits and coffee rank very low in Venezuela's export products, and (together with fish) make up for only 3.8% of the Venezuelan GDP in 2007.[68] This is well below the production of the same products in other Latin American countries like Colombia. However, there is great potential for agriculture given the vast areas with unexploited and fertile land and other resources necessary.[69]

As can be seen from Table 4.3, Venezuela more than doubles the need for agricultural imports in comparison to Brazil and Argentina. The efforts made to improve and expand the agricultural production are still at the earlier stages and Venezuela is still dependent on agricultural imports from other South American countries as well as from the United States.[70] Colombia is one of the major exporters of food to Venezuela. The recent political tension with Colombia implied the search for another partner that could provide an equally large share of food imports with low transport costs. Hence, Mercosur seems to be a suitable solution for this endeavor.

Table 4.3 Agriculture's share in the economy's total merchandise imports

	Agriculture's share in economy's total merchandise imports in percentage (%)	
Country/year	2000	2008
Venezuela	13.5	16.0
Argentina	6.5	5.6
Brazil	8.5	5.6

Data from: WTO (2009)

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[68] Economist Intelligence Unit (2009)
[69] ibid
[70] ibid

5. Shifting from CAN to Mercosur

Although the Venezuela-CAN relationship had a good start, integration and inter-regional free trade was terminated. One of the biggest integration projects in South American history was changed for another, even bigger project, Mercosur. On the 8th of December 2005, Venezuela took the first step towards integrating into Mercosur.[71] Venezuela had been granted access to the CU and the process to further integrate into Mercosur could continue. Yet to date, the complete acceptance of Venezuela remains in the hands of the Paraguayan parliament that has a last say on the issue.[72]

5.1 The shift

During the last years Venezuela has put emphasis on creating and enhancing the political and economic bonds with other South American countries. This is most likely rooted in the current Venezuelan political discourse that aims at diminishing the North American domination in the country and in the region. [73]

The political tension between the governments of Colombia and Venezuela is one of the aspects which motivated Venezuela's decision to shift from CAN to Mercosur. In 2005, the problems between the countries escalated in a territorial dispute.[74] The problems continued in the beginning of 2006 with Colombia's decision to agree on a free trade agreement with the United States. This was in stark contrast to the policy objective of Venezuelan president Hugo Chavez[75] and finally became the official reason to leave CAN.[76] In geo-political terms, the motivation to join Mercosur was therefore to meet a security threat,[77] in this case a possible conflict with Colombia. Behind this official logic, there are, however, other reasons for Venezuela's detachment from CAN.

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[71] Gutierrez (2006)
[72] Mercopress (2009)
[73] European Commission (2007), p.10
[74] BBC (2010)
[75] ibid
[76] Gutierrez (2006)
[77] Kaltenthaler & Mora (2002), p.80

CAN is a community situated between the two larger trade blocs Mercosur and NAFTA. It is possible that both Mercosur and NAFTA could provide Venezuela with larger influence on the international trade scene since integration in larger FTAs is supposed to add bargaining power.[78] Moreover the decision to actually join Mercosur instead of NAFTA is rather driven by politics, not economics. Joining the NAFTA would imply an alliance with the United States. Although the US is Venezuela's biggest trade partner, the current political climate would make it difficult to politically ally with the US on trade matters. At the same time, the Mercosur option instead offers alternative beneficial relations with the emerging giant Brazil and other trade blocs like the EU.

On the other hand, Mercosur's decision to allow Venezuela to apply for membership is not surprising. The oil-richness makes it a desirable country with the ability to meet the increasing energy demand.[79] Furthermore, the distribution of Venezuela's vast oil reserves through a proposed pipe-line displays a mutually beneficial opportunity for future trade relations.[80] However, critics of Venezuela's integration into the block have argued that Venezuelan politics and the nationalization of industries would make Mercosur a politicized trade bloc running counter the US and free trade ideas.[81]

5.2 The new tariff

Mercosur has a lower common external tariff than Venezuela. Yet, with Venezuela's legal agreement to harmonize its tariffs[82] this will lead to the decline of Venezuelan tariffs through integration.[83] The common external tariff between Venezuela and Mercosur is 10% for exports from Mercosur to Venezuela and between 8-9% for the Venezuelan exports to Mercosur. The shift therefore implies a redefinition of Venezuela's economic relations with its Andean partners after a period of five years (when the preferential trade agreements between CAN and Venezuela come to an end).

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[78] World Bank (2000), p.18
[79] Klonsky (2009)
[80] Trigona (2006)
[81] Klonsky (2009)
[82] Mercosur (2010)
[83] Wasilevsky (2007)

There are two important changes that occur through the change of blocs. Firstly, the change (although small) in demand and supply and, secondly, the disappearance of protection mechanisms. The first has to do with the fact that Venezuela had been a member of CAN since 1973. As mentioned in chapter four, the private sector had already become accustomed to the specific pattern of trade with the CAN countries and a change in trade partners does also imply a change in demand. One example is the Venezuelan automotive industry. Despite mainly consisting of assembly operations, this industry is one of the biggest industries in Venezuela after the petroleum and mineral based industries.[84] Becoming a full member of Mercosur could cause a change in trade patterns as Brazil is a bigger and more efficient automotive producer. Other severe complications can occur for both private and governmental firms since some mechanisms which protected national production within CAN countries would disappear for Venezuela.[85]

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[84] López (2002)
[85] Gutierrez (2006)

6. From CAN to Mercosur - Trade creation and trade diversion

As already mentioned, the ex-ante effects on welfare are difficult to predict (see chapter 2). However, the static effects of Venezuela's integration into Mercosur are presented in this chapter. The conditions developed by Jacob Viner, covered in chapter two, will be used to analyze whether trade creation or trade diversion effects dominate and hence leading to either positive or negative welfare effects. These conditions will then be applied to the empirical material at hand to predict the effects of Venezuela's entry into the Mercosur. At the same time this allows for conclusions to be drawn on the abdication of Venezuela's CAN membership. In other words, a comparison between the effects of (renouncing) CAN membership and the likely effects of Mercosur membership can be conducted. Still, the main emphasis lies on trade diversion and trade creation effects of entering Mercosur. The analysis of the relevant conditions will be carried out in the following order.

1. The size of the tariffs Venezuela-Mercosur before integration.
2. The size of the customs union.
3. The trade volume before the integration.
4. The similarity in economic structures within the customs union.
5. The proximity of the countries, geographically.

6.1 Size of tariffs before integration

*The effects that a customs union will have on the new member-state will depend on the **size of the tariffs** before and after the integration. The higher the original level of tariffs before integration, the greater will the trade creation effects be (as compared to the trade diversion effects).*

Venezuela and the four Mercosur countries have today a tariff level lower than the average for South America.[86] The average tariff-levels for Venezuelan exports to Mercosur lie at around 8-9%. On the other hand, Mercosur has eleven tariff levels ranging from 0 to 20%. This means that trade with those products which face the highest tariffs will benefit the most by integration to Mercosur. In the Venezuelan case trade with its main export product, oil, will

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[86] Inter-American Development Bank (2009)

not be very affected. Oil is a product which meets a large demand. Therefore, it meets low tariff levels. Even Mercosur's exports to Venezuela will face the elimination (complete and sometimes partial) of barriers through integration. This means that the 'new market', Venezuela, possibly will be desired market for Mercosur's greatest economic powers,[87] Argentina and Brazil, to enter. In certain areas, this may lead to more competition thus provoking more trade creation effects especially in areas where Venezuela is less competitive such as agriculture. However, protectionist measures in the agricultural sector as well as in the automotive sector are to be expected, thus diminishing the above mentioned trade creation effects.

Another way to interpret the abovementioned condition is to emanate from the more the tariffs are lowered after integration the greater the trade creation effects will be. Although the tariff levels of Venezuela and Mercosur are similar, integration implies a harmonization of tariffs. The consequence in Venezuela's case is a reduction of the tariff level, thus, leading to trade creation effects. These effects will only be small due to the small difference in tariff levels between Venezuela and Mercosur. An additional aspect which should be taken into consideration is the non-tariff barriers (NTBs). As can be seen in figure 6.1, Venezuela ranks relatively low on an NTB index where the values can vary between 0-10 (the higher level means fewer/lower non-tariff barriers), meaning that NTBs are higher or greater in Venezuela than in the other Mercosur countries. The NTBs reach even higher levels than the average in Latin America. If Mercosur does not succeed in its objective to eliminate NTBs, the implications of the high NTBs are increased effects of trade diversion.[88] The lack of supranational institutions within Mercosur poses a great difficulty in achieving this goal. This means that NTBs will continue to be present in Venezuela even after having joined Mercosur and thus implies that trade diversion effects will be greater than trade diversion effects.

Figure 6.1 Non-tariff barriers
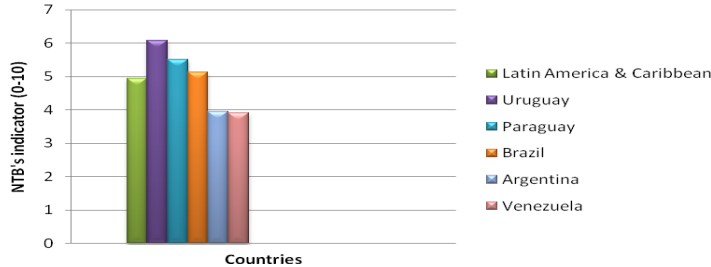
Computed data from: Inter-American Development Bank (2009a)

[87] Wasilevsky (2007)
[88] López (2002), p.1

6.2 Size of the customs union

*The effects that a customs union will have on the integrated country depend on the **size of the customs union**. The larger the customs union, the greater will the trade creation effects be (as compared to the trade diversion effects).*

The reason why this condition is important is the fact that the larger the customs union is, the larger is the possibility that the most efficient producers will be situated within the customs union. This thus leads to a smaller risk of trade diversion effects. However, this can lead to both advantages and disadvantages for Venezuela, as will be explained later.

The analysis can be divided into two parts. The first part concerns the size of Mercosur in relation to other countries or trade blocs in an international context. Mercosur (not including Venezuela) is a rather small global actor as figure 6.2 illustrates. It only stands for 1.7%[89] of the total world exports.

Figure 6.2 Mercosur exports in comparison with world exports
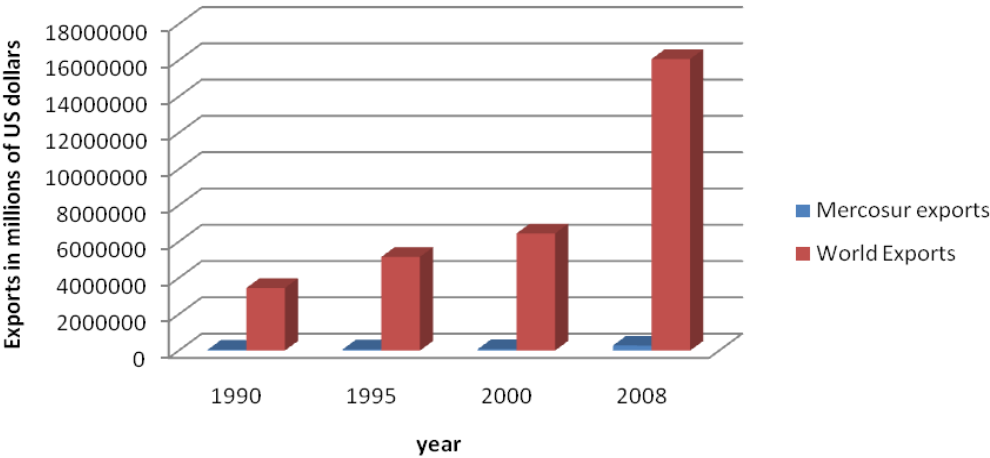
Computed data from: WTO (2010b)

Additionally, with its 250 million inhabitants, it only accounts for half of the population of the European Union.[90] Therefore, in relation to other regional blocs, integrating to Mercosur would lead to increased trade diversion effects than if integrating into a bloc like the EU.

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[89] Calculation using computed data from WTO (2010b)
[90] The current population of the EU (27 member states) is around 499.8 million (Marcu M, 2009)

The analysis on the size of the CU can scrutinize the trade diversion and creation effects from a regional perspective. Table 6.1 compares the value of exports in three different sectors: agriculture, fuel and mining and manufacturing. The subdivision into sectors allows for an analysis of the likelihood that the most efficient suppliers are situated in each of these three sectors.

Table 6.1 Value of exports by sector in Mercosur and CAN

Value of exports by sector (in billions of dollars)			
Block	**Agricultural products**	**Fuels and mining products**	**Manufactured products**
CAN	18.3	50.6	17.9
Mercosur	107.0	53.1	109.9

Data from: WTO (2009), p.24-25

According to Viner the larger the integration area (in terms of economic size), the greater are the trade creation effects due to greater possibilities of the most efficient producer being located in the integration area. As table 6.2 displays, Mercosur's production is superior in both manufacturing and agriculture. These are both sectors where the Venezuelan economy is rather uncompetitive. This superiority can be an opportunity for Venezuela to find efficient producers in these areas.

A Mercosur with more than double of the population and many times the area of CAN will therefore result in greater positive welfare effects especially in the sectors where Venezuela has a weaker position. Other effects which are not included in the Vinerian theory and which affect welfare are the increased consumption possibilities resulting from the large production.

The addition of a new country into a customs union is always accompanied by an increase in competition hence leading to gains for the consumers and loss for the firms which are not able to compete. One of the sectors which will face the most difficulties is the already struggling Venezuelan agricultural sector. The expanded agricultural production in Mercosur can lead to a debilitation of the Venezuelan agricultural sector or to an increase in protectionist measures as for example government subsidies or higher taxes on agricultural products.

6.3 Trade-volume before integration

*The effects that a customs union will have on the integrated country depend on **the volume of trade** before integration. The greater trade- volumes where before integration, the greater will the trade creation effects be (as compared to the trade diversion effects).*

Based on this condition, the following section will present the effects of the future Venezuelan integration. It will take into account former trade between Venezuela and Mercosur. As a source of comparison this part will integrate earlier trade with the CAN members.

In comparison with the rest of the world, Venezuelan trade with both CAN and Mercosur is fairly limited. Venezuela's trade consists mainly of trade with NAFTA (39.5%), followed by trade with the European Union (8.9%), CAN (7%) and Mercosur (4.7%).[91] The small amount of trade between Mercosur and Venezuela can lead to a less beneficial situation where the trade diversion effects are larger than the trade creation effects. A closer look at the trade between Venezuela and the two South American trading blocs indicates that even though trade has risen dramatically since 2003, the imports from Mercosur and CAN have again reached low levels (figure 6.3). Hence, this poses the risk of trade diversion being larger than trade creation.

Figure 6.3 Venezuelan imports from Mercosur and CAN 1995-2009
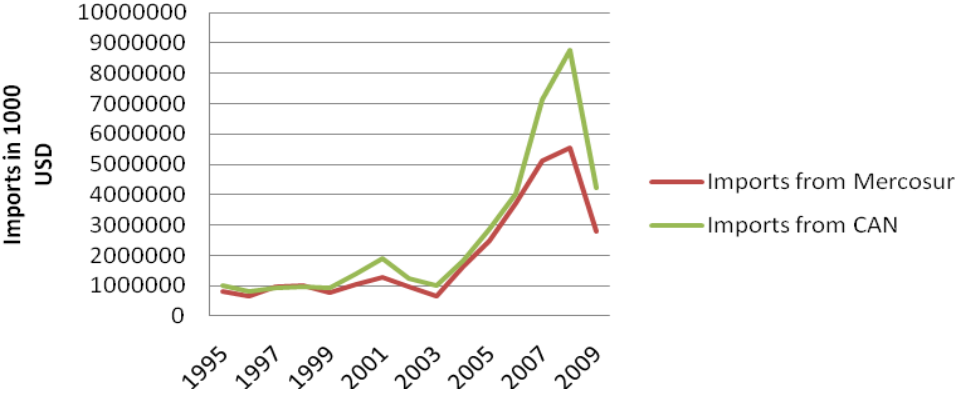
Data from: ALADI (2009)

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[91] European Commission (2009b)

The graph above illustrates the difference in imports between CAN and Mercosur. Imports from CAN reach a much higher level in comparison with imports from Mercosur. Trade with Colombia has been a major contributor to the high import level from CAN. In 2005, just before the resignation from CAN, trade with Colombia reached 2 billion dollars, that is, a higher level than the imports from any other CAN country. Imports from Colombia even reached 5 billion dollars in 2007 but have ever since decreased drastically. The big amount of trade can either mean that Venezuela traded more with CAN members because of integration. Or it can mean that proximity made Venezuela and Colombia natural trading partners. If trade was higher because of integration the results that can be expected may indicate more trade creation effects than if Venezuela and CAN countries were natural trading partners.

The export side also indicates a low trade level with both CUs as is indicated by figure 6.4. CAN appears to be a preferable trading partner even for the exports sector. However, after 2007 the exports to CAN have declined faster than the exports towards Mercosur. This could mean that Mercosur exports are increasing faster and that trade between Mercosur and Venezuela is increasing, however the fact that Mercosur exports are low before integration cannot be avoided. According to the condition a low trade volume implicates that the trade diversion effects are likely to be greater than the trade creation effects even when looking at the export side.

Figure 6.4 Venezuela's imports from CAN and Mercosur, 1995-2009.

Data from: from WTO (2010b)

In conclusion, total trade was quite low between Venezuela and Mercosur before the start of the integration process and it still remains very low resulting in trade diversion effects as a result of integration.

6.4 Similarity in structure

*The effects that a customs union will have on member countries depend on the **similarity of economic structure** between the integrating country and the block. The more competitive the economic structure, the greater will the trade creation effects be (as compared to the trade diversion effects).*

Venezuela's primary export products are raw materials while the country's main import products are more capital and land abundant processed products. In order to diminish the trade diversion effects, industries in Mercosur should be similar rather than complementary to the Venezuelan industries.   Table 6.2 indicates the top-five exports of Venezuela, Mercosur and CAN.[92]

Table 6.2 Top-five export products

Venezuela	Mercosur	CAN
27 Mineral fuels, mineral oils and products of their distillation...	27. Mineral fuels, mineral oils and products of their distillation...	27. Mineral fuels, mineral oils and products of their distillation.
72. Cast, iron and steel	87. Motor vehicles, tractors, and other vehicles	26. Ores, slag and ash
76. Aluminum and articles thereof	26. Ores, slag and ash	71. Pearls (natural) or cultured, precious or semiprecious stones
26. Ores slag and ash	12. Seeds and oleaginous fruits, seeds and fruit.	74. Copper and articles from it
29. Organic chemicals	02. Meat and edible offal	08. Edible fruit and nuts peel of citrus fruit (citrus), melons…

Data from: Inter-American Development Bank (2009b)

Venezuela, Mercosur and CAN have mineral fuels, mineral oils and products of their distillation as primary export products. Within these primary export products differences

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[92] Despite both Venezuela and Mercosur having Mineral fuels placed at number one they difference in the sort of fuels and oils which they export.

prevail which allow for complementarities rather than similarities in industries. For example, Venezuela's exports in the mineral sector are dominated by oil to a much larger extent than in both Mercosur and CAN. The complementarities in structure are also present in the agricultural sector. These products which are much needed by Venezuela are a central part of the Mercosur exports. This provides Venezuela with a complement to its own small agricultural sector and with a welfare gain in terms of a wider range of agricultural products than what CAN is able to offer.[93] However according to the condition above, it is similarities in structure which lead to trade creation effects because of competition. In Venezuela's case trade diversion is therefore to be expected.

6.5 Geographical location

The effects that a customs union will have on member countries depend on the **geographical location**. *The closer the countries are to each other the greater will the trade creation effects be (as compared to the trade diversion effects).*

Vinerian theory states that in order for the trade creation effects to be as great as possible the countries joining the integration should be, geographically, as close as possible. Applying this theory to the Venezuelan integration process implies that the trade creation effects would be larger than the trade diversion effects in CAN. This is due to CAN's smaller area compared to Mercosur.

The above mentioned condition is related to the transportation costs in the region. As mentioned in chapter three the transport costs in the region are high and the higher the transport costs the greater the importance of geographical proximity. Accordingly, CAN displays a better choice allowing trade creation effects to be larger than trade diversion effects. However, there is one exception to the trade diversion effects. The plans by Venezuela and Mercosur to build a pipeline from Venezuela to Brazil which would make the export of fuels more efficient and cheaper thus leading to an increase in the trade creation effects.

There are other set of effects which are related to the geographical proximity, such as increased bargaining power. However, despite their neighbor location many developing countries integrating do not work towards the same goal leading to lower welfare gains.

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[93] Comunidad Andina (2009).

Countries exporting the same product have a clearer goal and can therefore work together to reach this goal.[94] One example is OPEC, to which Venezuela belongs. OPEC has bargaining power strong enough to increase oil prices thus affecting the economy something that neither Mercosur or CAN have.

Despite the lack of cooperation between the integrating developing countries there is another factor that could increase the power of the individual country by integrating and that is the visibility brought by joining a trade block in the same region[95], because the more similar a set of countries is the more likely will they be working toward similar goals. In the case of Venezuela it is however difficult to work towards the same goals seeing that Venezuela is an oil producing country like no other within the Mercosur.

The shift from CAN to Mercosur, from a geographical location perspective seems to be of smaller importance because of the resemblance in geographical location and transport costs in both trade blocs. However, in general the trade diversion effects seem to be dominating over trade creation when applying the geographical.-location condition into Venezuela and Mercosur.

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[94] World Bank (2000), p. 123
[95] Nogués & Quintanilla (1992), p.187

6.6 Specialization

In order to determine the effects of integration the above sections took into consideration the trade creation and trade diversion effects on a general level which in the case of a country that is yet to join a customs union is not quantifiable. The *Revealed Comparative Advantage* (RCA) is however quantifiable. It calculates in which area the country will specialize after integration. These are linked to two models on comparative advantage; both the Ricardian model (technological advantage) and to the Heckscher-Ohlin model (with factor intensities and endowment) which in their turn are linked to the concept of comparative advantage.[96]

6.6.1 Comparative Advantage

The principle of comparative advantage was introduced by David Ricardo.[97] This concept implies that a country or party should specialize in the good where the opportunity cost is lower. While the Ricardian Model focuses on the price of the good being dependent on the quantity of labor used the Heckscher-Ohlin theorem builds on Ricardo's comparative advantage concept. It tries to explain the reason why a country has a comparative advantage on a certain product on the basis of factor endowments (labor and capital) of each party. [98] According to this theory a country has a relative abundance in one factor of production and will thus export the product which is factor intensive on that same factor of production. [99]

6.6.2 Revealed Comparative Advantage and Specialization

A specifically useful method for calculating the specialization effects of a country which is yet to enter a customs union is the method introduced by Balassa.[100] The method puts emphasis on the Revealed Comparative Advantage. It calculates in which industry the country has more advantages/disadvantages hence where the country will specialize when entering a customs union or another form of integration. Assuming that there is one product (j), a country (i) and a set of countries (s), the analysis of RCA can make use of both Balassa's formulae RCA1 and its alternative variation. RCA_2, can be used. [101]

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[96] Greenway & Milner (1993), p. 181
[97] Nello (2009), p. 77
[98] ibid, p.79
[99] ibid
[100] Greenway & Milner (1993), p. 186
[101] Greenway & Milner (1993), p. 186

$$RCA_1 = \frac{X_{ij}}{X_{wj}} \div \frac{\sum_j X_{is}}{\sum_i X_{ws}}$$

$$RCA_2 = \frac{X_{ij} - M_{ij}}{X_{ij} + M_{ij}}$$

> i = Country in question
> j = good j
> w = World
> s = set of products or all products
> X = Exports
> M = Imports
>
> X_{ij} / X_{wj} = i's share of world exports of j.
>
> $\sum_j X_{is} / \sum_j X_{ws}$ = i's share of all world exports or of a set of products or of all products

The RCA differs in the two formulas above. Both calculate the RCA however the difference between them is primarily that RCA_1 does not take into account imports.[102] If RCA1 is greater than 1 country i will have a RCA high enough to specialize in product j. Since the focus is put on exports in comparison to the exports of the rest of the world the results can very often indicate, especially in the case of developing countries, that the country should specialize in traditional products.[103] RCA_2, on the other hand, focuses on the internal trade performance and takes into account world imports. This alternative method also takes into consideration the fact that the export of a product does not exclude the imports of the same product. The ratio in which RCA_2 works is between the range of -1 and 1, where -1 reveals a comparative disadvantage and 1 a comparative advantage.

6.6.3 Venezuela's Revealed Comparative Advantage in the fuel sector

The high demand for fuels in South America combined with the high Venezuelan supply of fuels will focus this section of RCA on this commodity (Mineral fuels, mineral oils and products of their distillation; bituminous substances; Mineral waxes) which occupies chapter 27. The first step in order to calculate specialization is to calculate the RCA. In order to calculate the revealed comparative advantage at the regional level Balassa's[104] original formula below (RCA_1) will be used. The data from the Venezuelan fuel exports to Mercosur countries are put in relation to the data from Mercosur (CAN respectively) exports of fuels.

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[102] ibid
[103] ibid
[104] ibid

The result will then be divided by the ratio of Venezuela's exports to Mercosur against Mercosur exports within Mercosur.

$$RCA_1 = \frac{X_{ij}}{X_{wj}} \div \frac{X_{is}}{X_{ws}}$$

It ought to be mentioned again that the formula used does not take into account the imports of a country. The alternative formula RCA_2 which takes into account the imports can be used, especially when measuring the RCA of a developing country with significant exports of traditional goods (which is not the case of Venezuela, the fuel sector composing the greatest part of the exports).

6.6.4 Specialization: Venezuela- CAN

Venezuelan specialization will be put in relation to both Mercosur and CAN in order to provide a point of comparison. The following table indicates the export relations between Venezuela and the CAN-countries between 2000 and 2008 and the development of the RCA throughout the decade:

Table 6.3 Revealed Comparative Advantage: Venezuela- CAN

Year	2000	2006	2007	2008
$RCA_1 = \frac{X_{ij}}{X_{wj}} \div \frac{X_{is}}{X_{ws}}$	0,18818159	1,7565432	0,5340196	0,1654213

Computed data from: Inter-American Development Bank (2009b)

Despite Venezuela being a great exporter of petroleum the share of its petroleum going to the CAN-countries is relatively low. The results (RCA_1) from the table above indicate a low RCA_1 for Venezuela against CAN. In order for Venezuela to have a RCA over CAN strong enough to specialize in the fuel sector, RCA_1 must be higher than 1. The only year in which Venezuela had such an advantage was in 2006. This also implies that if Venezuela would have continued to be a part of CAN specialization would have had to take place in another sector than the fuel sector possibly increasing the possibilities of the agricultural sector to grow and develop.

6.6.5 Specialization: Venezuela- Mercosur

The RCA will be used in this section in order to analyze whether Venezuela's specialization in the fuel sector can continue after having entered Mercosur. Table 7.2 indicates the revealed comparative advantage in the fuel sector that Venezuela has over Mercosur.

Table 6.4 Revealed Comparative Advantage: Venezuela-Mercosur

Year	2000	2006	2007	2008
$RCA_1 = \dfrac{X_{ij}}{X_{wj}} \div \dfrac{X_{is}}{X_{ws}}$	8,13561018	8,9288441	5,5811127	5,2060823

Computed data from: Inter-American Development Bank (2009b)

 The results in the lower row of table 7.2 are all greater than 1 which indicates that Venezuela has a larger Revealed Comparative Advantage in the fuel and mineral sector in comparison to Mercosur. According to the results, Venezuela should continue to specialize in the fuel sector. Yet, the continued specialization in the fuel sector can also lead to negative consequences for example for the agricultural sector which can continue suffering abandonment. This can lead to a continued dependency on the agricultural imports from outsiders, most probably from Mercosur where some member countries such as Brazil and Argentina have a strong position.

The specialization of Venezuela can be linked to the similarity in economical structure of the country a CU (which can be seen in section 6.4). Competitiveness (similarity in structures) is meant to have an effect on specialization, therefore it can be said that the competitiveness in the fuel sector (because of the high RCA) can lead to increased trade creation effects.

7. Conclusion

The aim of this study was to assess the likely trade effects of Venezuelan integration into Mercosur and the continued specialization in the fuel sector. In order to achieve this, a resumed set of the original seven Vinerian conditions was applied to the Venezuelan case. The forward-looking kind of the study made these conditions essential in order to calculate the welfare effects of integration. Other aspects which had to be taken into consideration were the shift from one customs union to another and the country's oil based economy which differs Venezuela notably from other South American countries.

The circumstances under which Venezuela made the shift to Mercosur are relevant in the sense that the country's political relations with its second largest trade partner, Colombia, had debilitated trade with CAN significantly during the years preceding the shift. Weakened economical and political relations with Colombia meant the search for a new supplier, Mercosur.

To study the static effects of trade creation and trade diversion, Viner's conditions were set up. Out of the originally seven only five where analyzed because of their relevance to the specific case of Venezuela. The analysis on the tariff size indicated that a small reduction in tariffs through integration would lead to small trade creation effects. However, the study was not only limited to TB, NTBs also play a significant role for the static effects, especially in the case of Venezuela where NTBs reach considerable levels. The relative weakness of the Mercosur institutions leads to the assumption that NTBs will not be eliminated and thus leads to large trade diversion effects. The results are however ambiguous because of the difficulty in determining whether TBs or NTBs have the largest effect on trade diversion.

The analysis of the second condition dealt with the size of the CU. Mercosur is as a large regional CU, far larger than the Andean community. In terms of production and exports, Mercosur has a greater capacity than CAN in two important sectors where Venezuela has a weaker position: agriculture and manufacture. This thus means that the likelihood that of Venezuela finding an efficient producer in Mercosur is large and thus that the trade creation effects will dominate.

The results of applying condition number three to Venezuela indicate the dominance of trade diversion effects. According to Viner, condition three states that the higher the trade volume was before integration the greater the trade creation effects will be. The results indicate very low trade levels with Mercosur with the implication of negative welfare effects.

The condition dealing with the similarity in structure implies that industries are similar and therefore more competitive. The results showed a low level of similarity. Venezuela differs immensely from other South American countries in terms of its vast oil reserves, significant fuel production and a weak agricultural sector. This combination is supposed to lead to negative welfare effects in terms of increased trade diversion. Similarly, the analysis on the geographical proximity also resulted in increased trade diversion effects due to the geographical size of Mercosur combined with high transport costs in the region. However, the proposed pipeline between Venezuela and Mercosur could lower the trade diversion effects.

The approach used only allowed to determine whether trade creation or trade diversion dominates for each condition and thus if integration leads to positive or negative welfare effects. The analysis of the empirical case at hand indicated that trade diversion will dominate in four out of five applied conditions hence implying that the negative effects on welfare are greater. However, despite the generalized conditions being a fruitful resource in order to conduct this sort of ex-ante analysis, they also display a downside of the approach. The weakness lies in its inability to determine which trade diversion and trade creation effects have a larger impact on welfare. Yet, assessing the impact of either trade creation or diversion is an enormous endeavor that goes beyond the scope of this study.

An analysis of the specialization effects was primarily conducted in order to see whether Venezuela could continue its specialization in the fuel sector after having joined Mercosur. In order to calculate the RCA, which is needed to determine where a country should specialize, Balassa's initial RCA-formula was used. The results indicate a great revealed comparative advantage in the fuel sector thus allowing for a continued specialization in the sector. This result is, however, not taking into account the imports to Venezuela. A variation of the specialization study could be carried out applying the RCA_2 formula. This alternative study could have as main purpose to examine the specialization considering all other commodities apart from fuel. And thus add valuable information to the specialization possibilities of the country apart from fuels.

The Vinerian approach applied in the study of trade diversion and trade creation has certainly limitations as it takes an experimental approach conserving all other variables the same. It is especially difficult to apply a set of generalized conditions to any country which has not entered a customs union yet. Further analysis on the static effects of integration should be conducted in the future in order to solidify the here proposed results. Given that the consumption side is not taken into account in the Vinerian approach and in order to supply future studies with additional valuable information, an additional analysis on the consumption effects on integration would be beneficial. Also, this study limited the analysis to the static effects of integration. However dynamic effects such as bargaining power and political stability are also of importance especially in the case of Venezuela. Hence, in order to achieve a more complete image of Venezuela's shift from CAN to Mercosur an analysis on the other effects (apart from static effects) on integration can be recommended for future studies.

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