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Foreign Direct Investment (FDI) in MERCOSUR Agribusiness Sector

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Summary

This study analyzes the attraction of Foreign Direct Investment to the agro-industrial value chain of MERCOSUR countries. During the project, interviews to international and domestic entrepreneurs, investment fund managers, bankers and sector experts were conducted to collect updated and novel information and confirm previous hypotheses.

Agri-food production in MERCOSUR exhibits one of the best prospects in the world for future expansion. Reported review of the international literature strongly suggests that FDI has a potential beneficial role to play as a source of new investment, complementing local sources. International companies of the agro-industrial value chain (traders, agrochemicals, logistics, fertilizer, etc) are already present in MERCOSUR and have accompanied the strong development of the traditional agro-industrial sector over time. New FDI, responding to widening of world food demand, is attracted to MERCOSUR due to regional comparative advantage mostly based on farmland, MERCOSUR market size and Brazilian potential growth. Opportunities in crops, processed food, biofuels and dairy products are among the most relevant. On the contrary, there are several obstacles and bottlenecks that affect the agro-industrial development and FDI operation. Transport infrastructure, cost of capital and tax burden are among the most relevant in all four countries. Fertilizer availability and bureaucratic costs for doing business particularly affect the Brazilian market. Argentine business environment is negatively affected by political and macroeconomic risk. Uruguay presents a rather healthy business environment, though negatively influenced by macro crisis of the larger neighbor countries. Finally, Paraguay that is characterized by its comparative advantage in hydroelectricity suffers from the condition of a low income landlocked economy in need of massive infrastructure investment and organizational improvement. In depth analysis of norms and regulations affecting FDI shows a leveled playing field where foreign and domestic capitals are treated alike.

Domestic policies have been enacted to improve agro-industrial business situation mainly in Brazil and Uruguay, under the recognition of the potential beneficial contribution of this sector to the economy. Additional initiatives are needed in order to take full advantage of potential FDI inflows. This study concentrates in those recommendations operating at the regional (MERCOSUR) level. Among them the most relevant are: consolidation of the internal market for agricultural commodities and food; public initiatives and private-public partnership for investment in business infrastructure (transport and energy), reinforcing and broadening the scope of regional initiatives such as IIRSA and taking advantage of commitments in future free trade agreements by new partner countries (i.e. MERCOSUR-UE); leveling of the playing field and financing of domestic companies operating at the regional level to complement and compete with foreign ones; reinforcement of initiatives for financing and construction of infrastructure in Paraguay (less developed economy of the group) and structural development assistance to Uruguay (small economy); diffusion of each country's best practice for doing business to the region through MERCOSUR institutional initiatives (single window and other trade facilitation measures).

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Introduction

This study analyses the business environment to attract FDI² to the agro-industrial sector of MERCOSUR, the regional agreement of the Southern Cone that includes Argentina, Brazil, Paraguay and Uruguay as full member countries. The final aim is to provide the business community and the authorities of these countries and the region with: 1. a synthetic diagnosis of the situation regarding FDI in the agro-industry of the region, 2. an inventory of obstacles to investment as perceived by the businessmen and bankers in the field and 3. a set of sounding policies to improve the business environment in MERCOSUR as a whole.

The factors affecting the decision making process of a company, regarding business internationalization through direct investment have been analyzed extensively, both from the theoretical and empirical point of view. Even though the sequence of this decision may be different in each case, it will usually entail: a. the assessment of alternative countries to locate the project; b. the modalities of the project (greenfield FDI vs. M&As and fully owned subsidiaries vs. joint ventures) and economic returns to the project for each location, and c. an appraisal of the long-term implications of this decision within the company's general strategy taking into account that the probability of investing in a given country increases with the development of the firm's network in that country (Mayer et al, 2010).

From the economic point of view, modalities of FDI are divided into two categories: *horizontal*, driven by market access, and *vertical*, motivated by production cost differentials.³ Market access has proved to be a dominant motive for most of FDI that takes

² Definitions of FDI are contained in the Balance of Payments Manual: Fifth Edition (BPM5) Washington, D.C., International Monetary Fund, 1993) and the Detailed Benchmark Definition of Foreign Direct Investment: Third Edition (BD3) (Paris, Organization for Economic Co-operation and Development, 1996). According to the BPM5, FDI refers to an investment made to acquire lasting interests in enterprises operating outside of the economy of the investor. Some degree of equity ownership is almost always considered to be associated with an effective voice in the management of an enterprise; the BPM5 suggests a threshold of 10 per cent of equity ownership to qualify an investor as a foreign direct investor. Since the main feature of FDI is taken to be the lasting interest of a direct investor in an enterprise, only capital that is provided by the direct investor either directly or through other enterprises related to the investor should be classified as FDI. The forms of investment by the direct investor which are classified as FDI are equity capital, the reinvestment of earnings and the provision of long-term and short-term intra-company loans (between parent and affiliate enterprises). Divestment includes repatriated investments, reverse of intra-company loans and repayment debt to parent companies.

³ Vertical FDI takes place when the multinational fragments the production process internationally, locating each stage of production in the country where it can be done at the least cost. Horizontal FDI occurs when the multinational undertakes the same production activities in multiple countries. More sophisticated approaches have been introduced recently considering knowledge capital of MNEs (Markusen, 2002) and complex models, which propose integrated frameworks of these two core drivers. There are various theories in the

place between developed countries (57% of annual flows in 2008). It was also a main investment determinant for transnational companies (TNCs) in developing countries previous to the 90s, when barriers to trade created serious impediments to access developing markets through exports. More recently, the globalization process along with the acceleration in technological progress created the incentives towards “offshoring” of manufacturing and service production for cost-reducing motives. In this context, labor cost differentials, transportation costs, the existence of tariff and non-tariff barriers, the availability of critical resources, as well as government policy are generally held to be important determinants for the location choice.

Finally, *heterogeneity* of TNCs in the same industry due to differences in productivity, managerial organization, years of operation, country of origin, etc, have also been recognized as important factors that shape FDI modalities.

To fulfill the aim of this study all the previous characteristics of FDI should be taken into account and be combined in a diagnosis for the agro-industrial sector of MERCOSUR’s countries. At the same time the variety of factors and complexity of effects will demand special care for the organization of the information in order to select the relevant aspects for this case. For these reasons, the content of the following sections presents the results of the study following the approximate sequence of the decision making process of an international company deciding whether to invest in MERCOSUR agro-industry. Interviews conducted to international and domestic entrepreneurs, investment fund managers, bankers and sector experts were a useful means to collect information, confirm hypotheses and also to suggest the key issues of the sequence in the FDI decision making process. Various international data sources and previous literature completed the background of the study. When comparative analysis was introduced, Chile and South Africa were used as a benchmark.⁴

The content of the study is organized as follows: section 1 presents the general background of the MERCOSUR agro-industrial sector and the recent FDI performance into the sector; section 2 develops the sequence of the decision making process of an agro-industrial

economic and managerial fields describing the “push and pull factors” of FDI, for a recent synthesis see Hermansdottir (2008)

⁴ Chile and South Africa selection is based on the fact that those countries have developed an international well-known agro-industrial activity. Chile has won share in the international food market since mid-eighties, South-Africa follow a similar path since the 90s. Both countries have an aggressive offer to international markets. Chilean performance was characterized by their successful penetration of US market in association with local retail distribution and by the high sanitary standards pursued. South African case is interesting by the institutional evolution of the cooperative production sector into a world-class industry integrating production and logistics. They are also good benchmarking candidates in terms of development stage as regards MERCOSUR countries. Chile is a developing economy that exhibits a long-lasting growth process under an export-led strategy and South Africa is a developing economy one step behind our countries in terms of institutional organization and income level. Even though the similarities are important enough for the benchmarking exercise, differences are also very important. None of these economies hold the comparative advantage in crop and cattle observed in MERCOSUR countries. Unfortunately, similar country-cases in this aspect belong to the range of advanced economies (Australia, Canada, New Zealand) and they made their way towards development in a very different international scenario, where FDI role and flows were less important and development financing depended relatively more on domestic sources including trade surplus.

investment project paying attention to three main issues: risks, costs and opportunities. The sub-section on risk assessment includes political and economic risk indicators and the sub-section on costs analyzes production costs, transaction costs and main bottlenecks of the hypothetical project. Section 3 summarizes the opinion of investors and policy makers interviewed during the project and finally, section 4 develops a synthesis and draws some policy recommendations.

1. Background and selected indicators of FDI in the Agroindustrial Sector of MERCOSUR countries.

1.1. Recent evolution of FDI ⁵

After five years of continuous growth, global FDI was seriously affected by the international economic crisis since the end of 2007⁶, and particularly in 2009, when total inflow FDI fell to around USD1billion. In 2008 this flow was US\$ 1,7 billions and in 2007, USD 1,8 billions. UNCTAD(2009) prospects anticipated a recovering path for 2010 and 2011. Besides, USA and the BRICs (Brazil, Russia, India and China) are foreseen as the most likely countries to lead the future recovery. Brazil, for instance, kept the 8th position in the international ranking of FDI receptors, despite the fact of total FDI plunging by 57% between 2008 and 2009. With more than USD 20.000 millions, it ranks third among the developing countries, after China and India. (See Box 1)

During the crisis it became apparent that the flows to developing countries were more resilient and that South-South flows were increasing their relative importance in the total. In addition, there is a positive outlook for FDI in industries such as agribusiness in the near future since investors would prefer industries less exposed to business cycle like agriculture and food processing.

FDI comprises a variety of different business, contracts and economic actors. The most important participants are the TNCs. Other two participants whose shares have been growing over the last decade are the private equity funds and the Sovereign Wealth Funds. The latter focus their interest as direct investors in financial and service sectors through mergers and acquisitions (M&A). Almost 75% of the FDI by Sovereign Wealth Funds have

⁵ There are different types of FDI discussed in the literature: market-seeking, export-oriented, efficiency-seeking, resource-seeking, and asset-creating seeking investment. Each type is motivated by different factors in operation in the host country and relates to different effects on total investment and growth. In practice, FDI shows a much more complex pattern, combining various types.

⁶FDI shrank by more than a fifth in 2008 compared to 2007, according to estimates from UNCTAD. The factors that led firms to cut back capital spending at home, such as scarce credit, weak profits and uncertainty about demand, also hurt cross-border investment. The worst-hit countries were the developed ones, particularly in the European Union (FDI into Britain and Germany was around a half of its 2007 level, in Italy it fell by 94%). Flows into the United States, the biggest recipient of FDI, reduced only by 6%. Big emerging markets such as Brazil, China, India and Russia, exhibited increasing flows. This was also the case of South Africa, which showed the biggest increase, 111%. UNCTAD (2009)

been to developed countries, with investments to Africa and Latin America very limited so far. All of them are active in MERCOSUR countries.

One important characteristic of FDI inflows is that, investors try to build a balance between different regions responding to a strategy of covering all regions according to their prospects in the globalization process. On the other hand, the location by country in each region responds to conditions and perspectives of the local markets, including risk appraisal and production costs. The presence of critical resources, such as petroleum or land is also a main attractor. Agricultural competitive advantage of MERCOSUR countries fits well in this latter pattern.

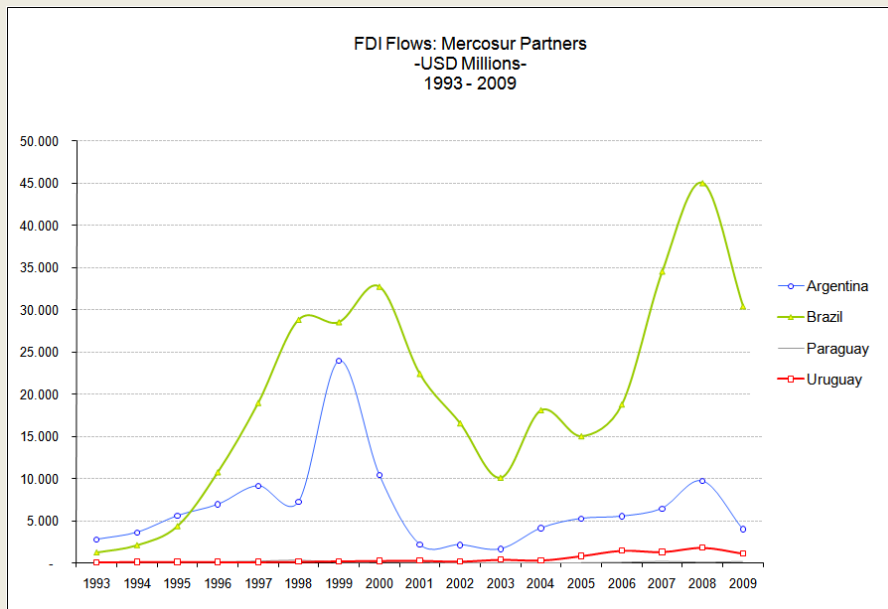
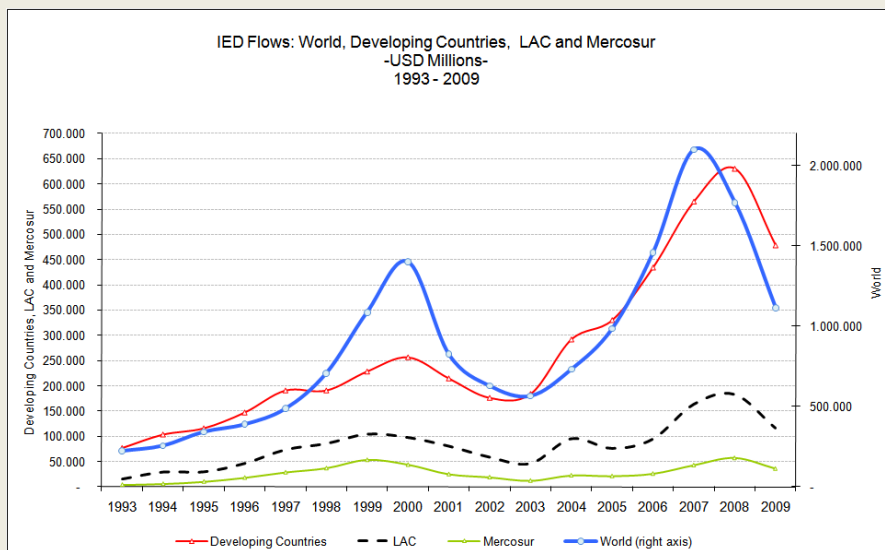
Another interesting characteristic refers to the capacity of financing new investment reflected by these FDI inflows. When considering the share of inward investments to annual net production flows as reflected by GDP, the only country exhibiting an increasing importance of FDI as a source of financing in MERCOSUR, is Uruguay.

Finally, trade agreements creating enlarged markets have also been pointed as factors of FDI attraction. In the MERCOSUR case, Cristini and Amal (2006) found that one important factor attracting FDI was the enlargement of the domestic market due to the agreement. An econometric exercise showed that an increase of 10% in the joint GDP due to the custom union (Argentina + Brazil + Paraguay + Uruguay) would cause a 1.2% increase in FDI stock. It must be also noted that the formation of the MERCOSUR as a “signal” to investors seemed to be more important than the “size effect”.

Between 2004 and 2007 there was a surge of FDI which in the case of Latin America and the Caribbean was mainly driven by the demand for natural resources. In 2007, FDI to this region achieved a historic high of USD 126000 millions. South America was the most important receptor (USD 72.000 millions) of inflows targeting extractive industries and natural-resource based manufactures. At the same time, agri-food TNCs based in Latin American countries continued their internationalization process at a slightly slower pace. Companies from Mexico and Brazil led this process, including outflows towards food and beverage sectors in developed countries.

BOX 1: FDI inflows in 1993-2008

In 1993-2009 Asian countries, particularly China, attracted FDI inflows in a very high proportion. In comparison, MERCOSUR's share has been relatively low but more stable than the one corresponding to the rest of developing countries and to Latin American countries as a whole. Inflows to our countries show an increase in the 90s during the liberalization process related to the privatization of public utilities, particularly towards Argentina. Until 2009, a new increase was observed, when Brazil achieved the highest share within the group.



Source: Own based on UNCTAD

Tables 1 and 2 summarize the performance of FDI inflows to MERCOSUR countries by source country and of MERCOSUR countries as FDI exporters. The first table confirms the idea that developed countries are the main source of FDI to our region. The importance of the European countries is dominant, particularly in the period of mid-nineties when privatization and concessions of public services took place in Argentina and secondly in Brazil.⁷ One interesting feature is the importance of intra-FDI flows (flows within MERCOSUR region), especially from Brazil to the rest of the regional partners.

Finally Table 3 summarizes the relevance of FDI in MERCOSUR as a source of financing. In this case the Table reports not only the inflows but also the FDI stocks. Ratios are estimated using the Gross Fixed Capital Formation (GFKF, a macroeconomic aggregate representing Total Investment) and the Gross Domestic Product (GDP) as reference values. Notice the higher level of FDI stock on GDP for Argentina, Chile and South Africa, denoting the importance of past accumulation. The Uruguayan and Chilean shares of FDI on Total Investment are noticeably high, indicating the importance of FDI attraction for development financing.

⁷ The origin of the FDI flows shows a significant change in the pattern between the 1980s and the second half of the 1990s. During this period, the European Union became the principal investor in the LA region, surpassing the participation of the United States in practically all of the countries except Mexico. EU companies considered Latin America to be the main target for investment in developing countries. Their participation showed a significant rise throughout the 1990s, passing from 34 per cent in 1992 to more than half in 2000. Among the countries in the region, Brazil was the main beneficiary of the FDI flows from the EU (43 per cent of the total European assets in LAC concentrated in the country), compared to 16 per cent in Argentina and 10 per cent in Mexico. In terms of flows, the MERCOSUR members, that had received 27 per cent of EU's FDI in 1994, received 82 per cent of total flows to Latin America in 1998. After that year, MERCOSUR's position decreased substantially and came to represent a participation of 47 per cent in 2002. The result largely reflects the Argentine crisis that generated the cancellation and retraction of investment in a series of projects by European firms.

Table 1

IED Flows in the host economy, by country or region of origin								
USD Millions and % of total								
By Country 1/								
	Argentina 2/	As % of Total	Brazil 3/	As % of Total	Paraguay 4/	As % of Total Flows	Uruguay 5/	As % of Total Flows
<i>World</i>	84.366	100,0	351.623	100,0	681	100,0	6.750	100,0
<i>Developed Countries</i>								-
United States	14.461	17,1	68.454	19,5	510	74,9	378	5,6
European Countries	48.626	57,6	177.218	50,4	101	14,8	1.416	21,0
<i>Developing Countries</i>								-
Mercosur Partners	na	na	6.237	1,8	135	19,8	1.922	28,5
Other LAC	na	na	50.660	14,4	0,9	0,1	298	4,4
Other Countries	18.241	21,6	49.054	14,0	(66)	(9,7)	2.735	40,5

1/ Includes Tax Havens

2/ Figures for Argentina corresponds to the cumulated 1992 - 2004.

2/ Figures for Brazil corresponds to the cumulated 1990 - 2009.

4/ Figures for Paraguay corresponds to the cumulated 2003-2009. and Uruguay cumulated 2001 - 2008.

4/ Figures for Uruguay corresponds to the cumulated 2001 - 2008.

Source: Own based on UNCTAD and Central Banks.

Table 2
MERCOSUR Countries as Foreign Direct Investors

Outflows of Direct Investment
Mercosur Partners by Destination
% of total cumulative flows
1992 - 2002

	Argentina	Brazil	Paraguay	Uruguay (*)
<i>World</i>	100	100	100	100
<i>Developed Countries</i>				
United States	21,5	19,6	2,3	1,3
European Countries	6,9	36,2	1,8	16,7
<i>Developing Countries</i>				
Mercosur Partners	13,7	9,8	67,8	58,0
Chile	11,6	7,3	0,1	7,6
Other LAC	42,4	25,8	1,8	16,2
<i>Other Countries</i>	3,9	1,4	26,2	0,1

(*) Figures for Uruguay corresponds to the cumulative 1990 - 2002.

Source: Own based on UNCTAD. Based on declaration of the host economies.

During the recent crisis, international business environment lost dynamism and fears of arising protectionism widespread. Until 2010, neither international trade nor FDI were heavily affected but for a few isolated cases. Prospects on this situation continue to show some degree of uncertainty, but international efforts actively search to avoid major distortions in these aspects. The general international trend towards greater openness persisted, including decisions to reduce corporate income taxes in order to improve FDI attraction. According to UNCTAD records, bilateral Investment Treaties (2676 in existence in 2008) continued to expand and Double Taxation Treaties increased in number (at present there are 2805 in operation). Investor-State disputes increased only slightly to 317 in 2008. As it will be explained below this has also been the prevailing situation in MERCOSUR. In the Argentine case, however, the breach of contracts in privatized public services after the 2001 crisis may have affected the business environment towards FDI.

In brief from this section, FDI has played an important role in economic development financing of MERCOSUR countries. Its relevance has been clearly growing in Brazil and Uruguay but the potential contribution has not been reached yet. Paraguay is also increasing the stake of FDI inflows in the economy. Argentina, on the contrary, has faced a reduction in FDI importance in the 2000s.

Table 3

Flows and Stocks of FDI					
Mercosur Members and Selected Countries					
Selected Indicators - ratios in %					
	2002	2005	2007	2008	2009
Argentina					
<i>Flows</i>					
GFKF / GDP	12,0	19,8	24,0	23,2	21,0
FDI / GFKF	18,3	14,7	10,3	12,9	6,3
FDI / GDP	2,2	2,9	2,5	3,0	1,3
<i>Stocks</i>					
FDI / GDP	42,3	30,1	25,7	23,3	26,2
Brazil					
<i>Flows</i>					
GFKF / GDP	16,4	15,8	17,4	18,7	16,7
FDI / GFKF	20,0	10,7	14,5	14,7	11,6
FDI / GDP	3,3	1,7	2,5	2,8	1,9
<i>Stocks</i>					
FDI / GDP	19,9	20,6	22,7	17,6	25,5
Paraguay					
<i>Flows</i>					
GFKF / GDP	17,3	19,3	17,4	17,4	15,0
FDI / GFKF	1,1	2,5	9,5	3,7	8,6
FDI / GDP	0,2	0,5	1,7	0,6	1,3
<i>Stocks</i>					
FDI / GDP	15,3	15,1	16,8	13,5	17,8
Uruguay					
<i>Flows</i>					
GFKF / GDP	11,9	15,3	17,5	19,3	18,3
FDI / GFKF	12,2	31,8	31,7	30,5	19,8
FDI / GDP	1,4	4,8	5,6	5,9	3,6
<i>Stocks</i>					
FDI / GDP	11,4	16,4	26,5	28,2	31,5
Chile					
<i>Flows</i>					
GFKF / GDP	21,3	21,2	19,8	24,4	21,7
FDI / GFKF	17,8	27,9	38,6	36,4	36,3
FDI / GDP	3,8	5,9	7,6	8,9	7,9
<i>Stocks</i>					
FDI / GDP	62,9	62,7	60,5	58,3	74,5
Sudafrica					
<i>Flows</i>					
GFKF / GDP	15,0	16,8	20,2	22,5	22,3
FDI / GFKF	9,4	16,0	9,9	14,5	8,9
FDI / GDP	1,4	2,7	2,0	3,3	2,0
<i>Stocks</i>					
FDI / GDP	35,4	32,0	38,6	24,6	44,0

Source; Own based on UNCTAD, IMF and Central Banks.

1.2. Recent evolution and prospects of the agro-industrial sector

For more than a decade, demand for agro-industrial products has been growing around the world. This increase has been mostly led by the increasing demand of developing countries that have been recording high rates of economic growth since mid-90s. On the one hand, the social promotion of Chinese and Indian population to higher levels of income (the so-called upsurge of the “middle class”) incorporated new customers to international food markets. On the other, until 2007 generalized economic growth in a wide array of developing countries imprinted new dynamism to the existing demand for agricultural products. In contrast, agro-industrial supply has been growing slowly as compared to the new needs. Since mid-2000s tight food markets translated into important increases of agricultural commodity and food prices. The international financial crisis of 2008-2009 sharply put a stop to the international growth trend. However, food markets and emerging economies resulted relatively less affected by the crisis and there are strong and well founded expectations that the subsequent recovery will keep intact the prospects of the previous scenario in the case of agro-industry. MERCOSUR, as a whole, is among the most important potential contributors to the agro-industrial supply expansion in the world.

To be able to seize this opportunity, MERCOSUR countries will have to overcome several weaknesses. First, due to their condition of developing countries, their agro-industrial value chains exhibit shortfalls that will have to be solved in order to take advantage of the new context. Among the most important, the following can be mentioned: the availability of infrastructure for transportation of the increased production, the financing of new investment and the access to and diffusion of new technologies.

Second, the situation of agro-industrial competitiveness differs by product and region in each member country. Some of them are already leading exporters of selected agro-industrial products. It is the case of vegetable oil in Argentina and Brazil; frozen orange juice and bioethanol in Brazil; beef in Brazil, Uruguay and Argentina. Paraguay is an important soybean exporter to the MERCOSUR region⁸. All of them are able to expand farm land use, but costs will be increasing in the medium run.

Third, modernization of logistics and agro-industrial infrastructure has been improving but, on average, transport costs are higher than those of other competitors in advanced countries such as Canada, New Zealand or Australia. As regards financing of new investment, it has been historically scarce in Latin American countries. In the 2000s, improved business climate and macro stability in Brazil has resulted in higher domestic investment and has attracted new foreign capitals, both financial and for direct investment. Uruguay also exhibits an improving

⁸ The Paraguay River divides the country into two distinct geographic zones: the western region or Chaco, which occupies 61 per cent of western Paraguay, has broad flatlands and xerophytic woodland. The eastern region, which has large areas suitable for subtropical agriculture, has seen rapid growth in the production of soybeans and in fattening livestock. The south, east and north-east subregions in the eastern part of Paraguay are the most dynamic agricultural areas as these are where the production of soybeans and cereals is concentrated.

performance, followed by Paraguay. Argentina's financial crisis of 2001-02 limited the country's attractiveness to foreign investors.

In brief, the opening of a potential opportunity for growth in the agro-industry, the need to modernize the value chain and the requirement of new financing sources for this development are key issues to be analyzed in the MERCOSUR case. Moreover, to develop a fruitful analysis the different points of departure for each country as regards agro-industrial needs and opportunities also have to be taken into consideration.

The Agroindustrial Value Chain in MERCOSUR

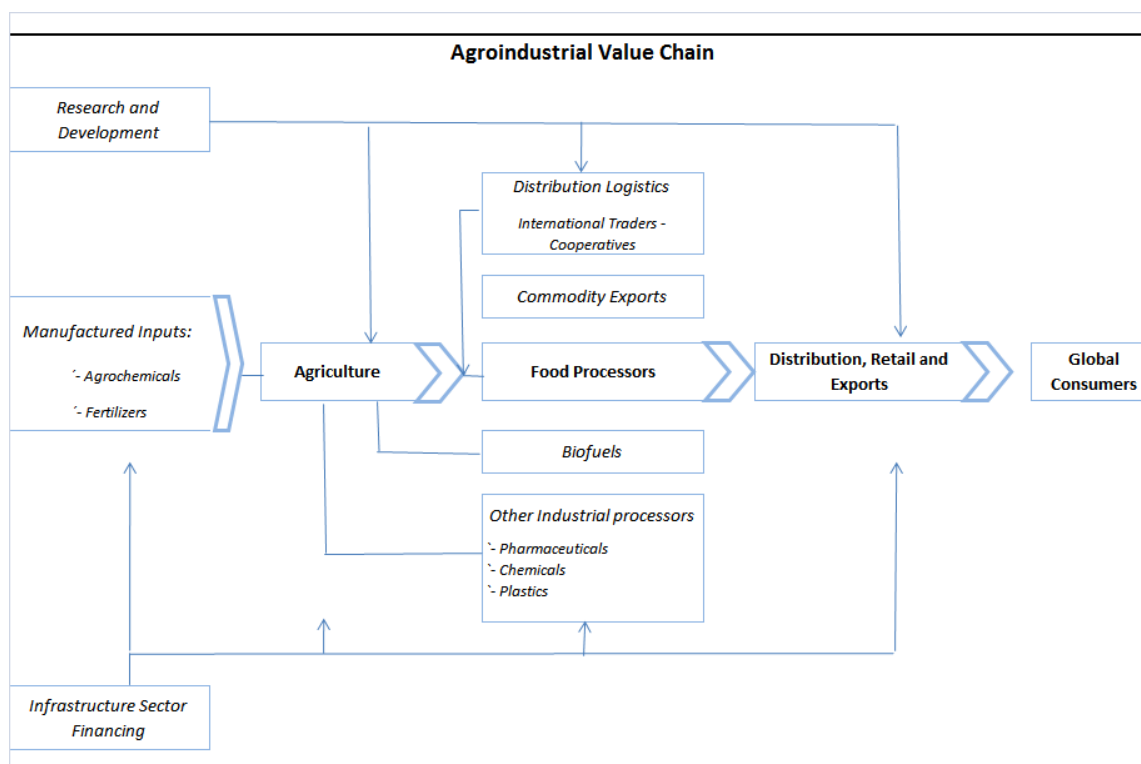
Agricultural production and food processing are at the core of the agro-industrial value chain. This activity includes primary agricultural production, primary processing of food ingredients, final food production plus the preparation and packaging of fresh products and the industrialization of non-food products and co-products (feedstock products, biofuels, inputs for the pharmaceutical or agrochemical industry, etc).

However, the agribusiness value chain is not only composed of the core of the business but also of the linkages with other manufacturing and service activities providing key inputs for the process. Linked manufacturing activities are: the production of agrochemicals, agricultural technology and biotechnology, manufacturing of agricultural machinery and food processing machinery, etc. Linked service activities show an important share in total agroindustrial costs and are composed of land transport and storage services, food logistics, fluvial, maritime and air carriers, etc. Services for wholesale and retail distribution complete the "downstream" linkage of this value chain.

Investment in the core business determines the successful evolution of the value chain by increasing growth in the medium run at sustainable rates. This result is to be achieved provided that the other components of the value chain do not pose serious constraints to this development. The derived demand of a growing agricultural sector could create "bottlenecks" up or downstream of the chain provoking over-costs or directly delaying expansion. In that case, additional investments will be needed to release the constraints in operation.

The following chart presents a stylized view of the agro-industrial value chain that illustrates the potential importance of the bottlenecks that will be analyzed further in this study.

Figure 1



Source: Own based on Wilkinson, 2004 and Rezende Lopez, 2002.

In Brazil the agrifood economy is equivalent to 30% of the country’s GDP; it represents 35% of total employment and 40% of total exports (2004 figures)⁹. In Argentina, the whole agricultural and agro-industrial sector amounts to 18.5% of GDP, agricultural and agro-based manufacturing exports continues to hold a high share of total exports, around 50-55% and the sector employment (direct and indirect) represents approximately 36% of total employment (Nogués and Porto, 2008). These figures exceeds the ones corresponding to the Agriculture and Food GDP shares that only take into account the value added of each sector without considering the whole value chain (see GDP figures in Statistical Annex)

In the 90s, many analysts, particularly in Latin America, have supported the idea of “export pessimism” for countries that based their export-led growth strategy on agro-industrial exports. This view followed from the fact that the growth rate of manufacturing exports has far exceeded that of processed foods. Even though the rationale for export pessimism failed to recognize the potential benefits of a distinct comparative advantage for food production in many LA countries, the prevalence of this idea delayed needed public investments in infrastructure in several cases (Argentina is a clear example of this fact). More recently, the “westernization” of Asian food diets along with the diversification of uses for agricultural production (i.e. biofuels), has led to a reconsideration of these ideas. In the 2000s several countries in the region, such as Chile, Brazil, Uruguay and, very recently, Colombia

⁹ See Chaddad and Jank (2006)

actively searched for the development and internationalization of their agro-industrial companies. Argentina is behind their MERCOSUR partners in this reconsideration of the role of agro-industrial sector in development. This country maintains an important gap between the potential contribution forecasted by technical studies and the actual performance of the sector. The current situation of Paraguay, characterized by a poor endowment of infrastructure and technology in the food sector, suggests the need for heavy investments to move their agroindustry one step forward.

Finally as regards the characterization of the agro-industrial sector in MERCOSUR, the following Table shows the breakdown of the agro-industrial exports for each country¹⁰. Similarities are to be expected due to the continuity of the natural endowment of land across these countries. For instance, one important aspect to keep in mind is the fact that the agricultural supply of our countries to the rest of the world is coincidental in several products where Mercosur countries hold an international leadership. This concentration translates into a pole of production at large scale that has traditionally attracted international investors, whose presence seems to be increasing with the new opportunities underway. However, agro-industrial development in each country has interesting differential characteristics. Traditional tropical products included in the Brazilian basket are the major difference. Paraguay exhibits a larger share of non-food products in its composition.

Very briefly, evidence on agroindustrial development in MERCOSUR allows for prudent optimism. According to Athukorala and Sen (1998), the share of manufacturing exports in total exports increased from 66% to 81% between 1970 and 1994, and developing country share in manufacturing exports augmented from 6% to 24%. The value of processed food in comparison with primary product exports increased from 26% to 37%. Argentina and Brazil, out of the five developing countries at the top of the food exporting ranking, were responsible for 40% of total food exports. After a short period of low international prices and reduced demand in late 90s, the international food market recovered dynamism and in mid-2000s “the food price crisis” alerted on the profound changes affecting the international agricultural markets. At present, MERCOSUR supply of agricultural commodities is leading the world markets in various products and food processing has improved noticeably.

¹⁰ Table 4 shows the shares corresponding to exports above USD 1000 millions. See complete information in Statistical Annex.

Table 4

Argentina: International Trade-Selected Indicators Agricultural and agribusiness sector		Brazil: International Trade- Selected indicators Agricultural and agribusiness sector	
	2008		2008
Exports (USD Millions)	70.021	Exports (USD Millions)	197.942
Agricultural and Agroindustrial Exports (as a % of Total Exports)	57,1	Agricultural and Agroindustrial Exports (as a % of Total Exports)	31,0
Main Products (as a % of Total Exports)	39,9	Main Products (as a % of Total Exports)	22,2
Main Products (USD Millions)		Main Products (USD Millions)	
Meal and residues from the extraction of soybean oil	7.118,2	Soybean whether or not broken	10.952,2
Soybean oil	4.711,3	Frozen chicken meat, fresh or chilled	5.822,0
Soybean	4.555,3	Meal and residues from the extraction of soybean oil	4.363,5
Corn	3.417,4	Raw coffee beans	4.131,5
Wheat	2.541,8	Beef frozen, fresh or chilled	4.006,1
Fruits Complex	1.570,0	Chemical wood pulp	3.901,1
Sunflower oil	1.404,9	Sugar cane, raw	3.649,6
Leathers	964,0	Tobacco	2.683,2
Beef	826,2	Alcohol	2.390,1
Milk	823,0	Soybean oil (raw)	1.984,5

Paraguay: International Trade- Selected indicators Agricultural and agribusiness sector		Uruguay: International Trade- Selected indicators Agricultural and agribusiness sector	
	I half 2008		2008
Exports (USD Millions)	2.278	Exports (USD Millions)	5.949
Agricultural and Agroindustrial Exports (as a % of Total Exports)	93,6	Agricultural and Agroindustrial Exports (as a % of Total Exports)	65,9
Main Products (as a % of Total Exports)	68,3	Main Products (as a % of Total Exports)	60,8
Main Products (USD Millions)		Main Products (USD Millions)	
Soybean	865,3	Beef	1.222,9
Beef	348,6	Agricultural Products	1.132,6
Soybean oil	206,1	Forest Products	461,9
Wood	55,5	Dairy products	434,4
Leathers	25,1	Wool	167,4
cotton fibers	15,9	Citrus fruits	82,8
Sugar	21,1	Lamb meat	70,7
Tobacco	10,7	Honey	28,2
Essential oils	5,2	Wine	10,6
Coconut oil	2,3	Non-citrus fruit	5,5

4/ Author's calculations based on Yearbook 2009 - MGAP.

Sources: Argentina: INDEC; Brazil: Secex; Paraguay: Foreign Trade Bulletin. BCP / Rediex ; Uruguay: Yearbook 2009 - MGAP.

1.3. FDI attraction and potential contributions to the development of the agro-industrial sector in MERCOSUR

Benefits stemming from FDI have been widely recognized by the specialized literature. Firms investing abroad are, on average, more productive and larger. Also, firms with intangible assets (e.g. product licenses) are more likely to invest abroad rather than to engage in exporting activities.¹¹ From the point of view of developing countries interested in FDI attraction, TNCs are a source of assets that are scarce and difficult to produce domestically. This includes intangible assets such as technology, management skills, channels for marketing products internationally, product design, quality characteristics, brand name, etc. At the same time, firms investing abroad may be subject to paying an additional fixed cost for establishing in a more risky business environment that increases the threshold of operating profit that the firm must achieve to consider FDI as profitable (Mayer et al, 2010).

The effects of FDI on investment may well vary from country to country, depending on domestic policy, the type of FDI that a country receives, and the strength of domestic enterprises. Agosin (2008) points out that under certain circumstances FDI may be expected to induce additional investment from national firms (“crowding in” effect). Under other circumstances, FDI may well displace investments that would have been made by domestic firms in the absence of the foreign investor (“crowding out” effect). Though the prevalence of one of these effects is an empirical matter, the likelihood of a crowding in effect conveying to higher total investment increases in the presence of backward and forward linkages and when the new (greenfield) investment is attracted to sectors where business opportunities have not been completely exploited by nationals due to technology or financing restrictions.

Positive spillovers in technology and productivity take place when the presence of affiliates of international companies in the domestic market improves the situation of national companies in the same sector (horizontal spillover) or backward and forward in the chain of production (vertical spillover). In the case of Argentina, Brazil and Uruguay, Laplane (2006) finds that vertical spillovers are present in the manufacturing sector and suggests that absorption capacity by domestic companies is a strategic factor in order to be able to take advantage of this effect.

Some countries have implemented fiscal and financial incentives to attract foreign investors. Even though these incentives may play a role for TNC decisions on the margin, the most important factors to attract FDI continue to be market characteristics, relative production costs and resource availability. Moreover, these incentives can only be justified if the foreign firms differ from local companies in that they possess some firm specific intangible asset that can spill over to local firms. In that case, the foreign investor’s private benefits are lower than the social benefits and total investment will fall short of the optimal amount unless investment incentives compensate the foreign investor (Blomström, 2002).

¹¹ FDI can be seen as a way of keeping control over the relationship with customers, notably for firms with more intangible assets.

However, notice that when governments compete to attract FDI there is a tendency to overbid and the subsidies may exceed the benefits. Besides, the difficulty to assess the likelihood of any spillover advise making incentives available on equal terms to all investors, foreign and domestic alike.

Finally, it is worthwhile noting that several studies have also reported negative effects stemming from FDI. In particular, foreign companies may operate in “enclaves”, without linkages to the domestic production system. Under special circumstances they may cause a greater concentration of the market, reducing competition and welfare.

The agro-industrial value chain has experienced many of the positive effects of FDI in the developed countries and this experience may be now extending to the developing ones. As it was abovementioned, in recent years the global market for processed food has been shifting towards developing countries. At the same time, world trade in processed food has been growing in response to increasing consumer demand for diversified diets. Consequently, FDI flows in agricultural production tripled to US\$3.000 millions annually between 1990 and 2007. This amount, however, represents only the 0,2% of total FDI flows in 2008. FDI in the food and beverage sector is more important in comparison. It amounted to US\$ 40 billions and represented 2,4% of the total in 2008.

Since the food crisis in 2007-08, motivations for FDI in the food sector have widened. In particular, Asian and Middle East countries have oriented public and private funds to search for natural resources and farming activities to provide to their home markets invoking reasons of national food security.

Agro-industrial chains have particular characteristics that emphasize the benefits generally recognized to FDI. Basic food can be served through commodities which are fluidly traded in international markets. Instead, trade of more sophisticated food requires knowledge on consumer’s behavior and building-up of trust as a food supplier. In fact, in the processed food markets international brands reduce the cost of acquiring reputation in the international food markets and the cost of access to new markets. Compliance with international standards and follow-up of dynamic changes in food trade (changes in preferences and market structure) may be costly. Moreover, to circumvent sanitary, technical and transport barriers is not only a costly activity but one subject to scale economies, difficult to cover for medium companies operating from developing countries. Finally, concentration has taken place in several stages along the global agro-industrial value chain, particularly in agrochemical and biotechnology activities where Research and Development (R&D) investment is the key to success.

The presence of benefits stemming from FDI in the agro-industrial sector does not mean that domestic companies will be unable to make their way to international markets as several Brazilian and, to a minor degree, some Argentine companies have demonstrated. It only means that participation of foreign capital in agro-industrial local development may be “capitalized” as a profitable link in the whole value chain.

Main benefits identified in this chapter are summarized in the following Table.

Table 5
FDI in agro-industry
Main benefits

Benefits related to:		Importance
Costs		
Labor	Training of skilled labor increase in labor productivity	+++
Technology	Access to new technology Modernization of managerial skills Transfer of techniques for inventory and quality control	+++
Financing	Access to international financial markets at lower interest rates	+
Market		
Access	Access international high income markets	++
	Follow-up of dynamic barriers to trade	++
Consumer's preferences	Follow-up of changes in preferences.	++
	International brand to create trust as a secure food supplier	+
Growth and development		
Productivity	Technology spillovers to local input suppliers, client companies and competitors Improve competition in the local market	++
Crowding in	Inducement of additional investment of domestic companies	+

Note: importance assigned according to opinions in specialized literature. See references.

Source: Own based in Blomström (2002) and Makki, Somwaru and Bolling (2004)

For instance, some of these benefits have already been recorded in the MERCOSUR case. According to Farina and Santos Viegas (2002) one of the benefits of global insertion of the food industry in Brazil was that the vigor of competition reflected in declining real prices of food in the long run.

TNCs have also expressed their interests and concerns regarding agricultural growth in developing countries. For instance, Nestlé considers that the most critical topics for volume and quality growth in agriculture are water, energy, technology (genetic potential, fertilizers), knowledge and know-how (farming practices and management).

Several case-studies have also documented that FDI can contribute to efficiency by breaking supply bottlenecks due to technological pitfalls, but this effect may become less important as the technology of the host country advances.

UNCTAD (2009) asserts that developed-country's TNCs are dominant in the upstream (suppliers) and downstream (processors, retailers, traders) ends of the agribusiness value chain. In agricultural production, FDI from the South (including South-South flows) is equally significant as FDI from the North. At this level, the participation of foreign

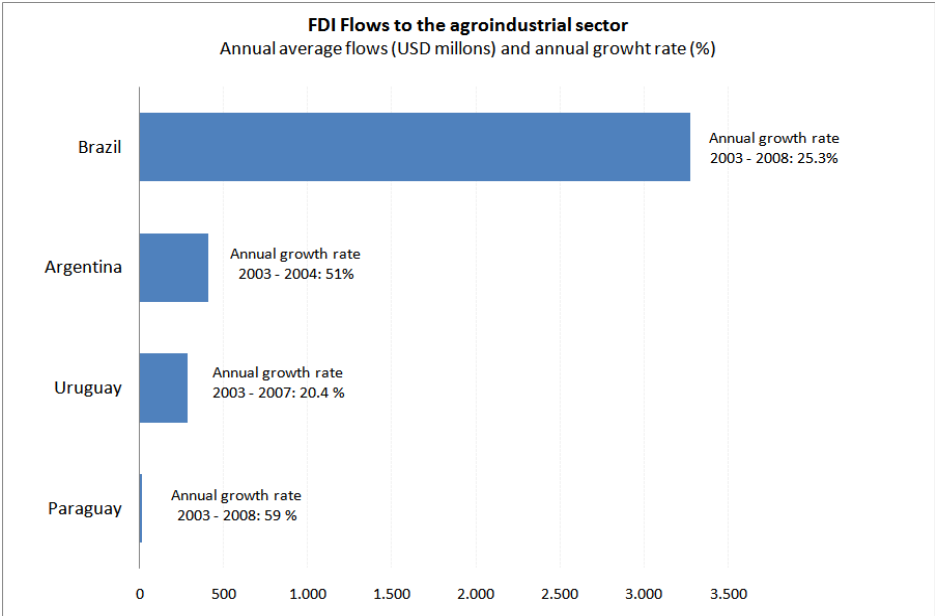
investors includes “contract farming” activities, covering 110 developing countries worldwide.

The following Figure shows the evolution of FDI inflows to MERCOSUR countries in agroindustry. FDI to the agricultural sector has been very important in the Argentine case, which has received interesting amounts of investment in agriculture. Investors in agricultural production have bought agricultural establishments (land) but have also participated in agricultural pools specialized in short term tenancy contracts for production and trading of grains (mainly soybean). According to this information, Uruguay was the country receiving the highest share of FDI in agroindustry, meanwhile Paraguay exhibits a net outflow from the sector.¹² (See structure of FDI by economic activity sector in Statistical Annex)

Since the 90s, processed food exports from developed countries have been accompanied by waves of FDI into the food processing sector of developed and developing countries alike (Wilkinson, 2004). In the case of FDI by the US food-processing industry, Makki, Somwaru and Bolling (2004) find that market size, per-capita income, and trade openness significantly affect US decisions to invest abroad.

Benefits from FDI participation in the MERCOSUR agribusiness sector have to be balanced against potential risks. Among them, Wilkinson (2004) has pointed out the following: increase in industrial concentration, displacement of small agricultural producers, restricted scope of competitive production to the LA region and the domestic adoption of highly processed food diets.

Figure 2



Source: Own based on UNCTAD and national Central Banks.

¹² Information for Paraguay is collected through a survey to main foreign companies in the country.

Developed countries, particularly the US and several EU member-countries (France, Germany), have witnessed the globalization of its leading firms in the food industry with the potential for exploiting global brands.¹³ MERCOSUR has been an important recipient of US investment in agribusiness; 60% of this investment in food processing in our region went into the Brazilian market.

In the case of EU, at the beginning of the 2000s, four companies were among the world's top 15 agri-food leaders by value of sales: Nestlé, Unilever, Diageo and Danone. Ten companies out of the fifteen belonged to USA and one to Japan. Besides, an important number of European companies are leaders in their respective food sub-sector (Cadbury-Schweppes, Heineken, Parmalat, etc). Many of these companies held a traditional presence in MERCOSUR countries due to historical ties and close cultural bonds. Many of them increased their stake in the region since the 90s. However, the consolidation of the European Single Market, the EU enlargement towards Eastern Europe and the importance of the opening opportunities in Russia re-oriented European interests towards these new recipients of investment flows as compared to MERCOSUR countries.

In the case of Japan, until the early 2000s the dominant strategy of Japanese food multinationals has been to develop off-shore production for supplying the Japanese market. However, this source has fluctuated over time and has concentrated in neighbor Asian countries.

MERCOSUR as the source of agrifood multinationals: Table 6 reproduces the list of main agribusiness companies in LAC ranked by sales. Many are hosted or belong to nationals of Brazil and Argentina. According to the position in the ranking, it can be assessed that these two countries have very important stakes in the market. By 2000, 8 out of the 10 largest food companies in Brazil were multinationals, while in 1994 they were only 5. Foreign companies made 80% of the acquisitions of Brazilian food companies in 1996/97. Argentina, USA and Italy were traditionally the leading countries investing in Brazil's food industry. In 1998/2000, others such as Ireland, Mexico and Chile joined them.¹⁴

Considering the largest (non-financial) TNCs operating in agro-industry in LAC around 2004, Bunge and Cargill were the most important ones by sales, with their core business in the traditional commodity market but with stakes in vegetable oil, biofuels, food and fertilizers among others. Unilever and Nestlé (food); Carrefour (food retail); Coca-Cola and Pepsi Cola (beverage) and Basf and Dow Chemicals (agrochemicals) were at the top of the ranking by sales in Brazil and Argentina. (Red MERCOSUR, 2006). The important novelty of recent years has been the climbing of Brazilian (internationalized) companies to the top of the ranking (See Table 6 below).

¹³ United States companies account for 40% of the world's top fifty food processors.

¹⁴ 2127 M&A operations were carried on from 1994 to 2000 in Brazil and foreign capital was present in 60% of these operations, 12% corresponded to the food sector approximately. Most of the national firms involved were family owned, presented problems of succession, were highly indebted and faced increased competition. Farina and Santos Viegas (2002)

Table 6

Agribusiness Companies Between de 500 Largest Companies in LAC By Sales in 2008. USD Millions					
Ranking (By sales)	Company	Host Country	Sector	Sales 2008	Sales 2007
18	JBS FRIBOI	Brazil	Agroindustry	12.982,6	7.983,7
22	FEMSA	Mexico	Beverages	12.146,9	13.517,8
37	BUNGE ALIMENTOS	Brazil	Agroindustry	9.521,1	8.780,1
41	AMBEV	Brazil	Beverages	8.942,9	11.092,5
56	CARGILL	Brazil	Agroindustry	6.853,9	7.146,5
61	COCA-COLA	Brazil	Beverages	6.418,5	6.764,0
62	COCA-COLA FEMSA	Mexico	Beverages	5.998,6	6.344,2
65	CARGILL	Argentina	Agroindustry	5.970,2	4.721,9
66	GRUPO BIMBO	Mexico	Food	5.951,0	6.723,8
74	GRUPO MODELO	Mexico	Beverages	5.448,2	6.678,0
76	NESTLÉ	Brazil	Food	5.369,4	7.045,8
82	PERDIGÃO	Brazil	Food	4.875,1	3.744,9
89	SADIA	Brazil	Food	4.590,8	4.868,3
123	GRUPO PEPSICO	Mexico	Beverages	3.300,0	3.498,0
126	GRUPO MASECA	Mexico	Food	3.238,2	3.281,1
133	CERV. CUAUHTÉMOC MOCTEZUMA	Mexico	Beverages	3.075,7	3.337,5
137	GRUPO INDUSTRIAL LALA	Mexico	Food	3.000,0	3.013,0
142	NESTLÉ DE MÉXICO	Mexico	Food	2.855,0	2.907,3
146	GRUPO BERTIN	Brazil	Agroindustry	2.835,2	2.924,0
158	MARFRIG	Brazil	Agroindustry	2.654,6	1.885,6
170	ACEITERA GENERAL DEHEZA	Argentina	Agroindustry	2.506,0	1.396,3
180	GRUPO BAVARIA	Colombia	Beverages	2.322,0	2.452,0
182	MOLINOS RÍO DE LA PLATA	Argentina	Agroindustry	2.307,8	1.784,3
187	SOUZA CRUZ	Brazil	Agroindustry	2.268,1	2.736,3
194	LOUIS DREYFUS COMMODITIES BRASIL	Brazil	Agroindustry	2.228,6	2.235,8
210	ARCOR	Argentina	Food	2.064,7	1.846,4
212	COSAN	Brazil	Food	2.038,2	1.772,5
213	PHILIP MORRIS DE MÉXICO	Mexico	Agroindustry	2.035,0	2.164,4
227	SIGMA	Mexico	Food	1.886,9	2.114,5
230	COAMO	Brazil	Food	1.853,2	1.797,2
239	GRUPO NAC. DE CHOCOLATES	Colombia	Food	1.780,7	1.687,5
246	SUZANO PAPEL E CELULOSE	Brazil	Pulp / Paper	1.738,8	1.925,0
247	DANONE	Mexico	Food	1.720,7	1.334,7
253	COPERSUCAR	Brazil	Agroindustry	1.682,9	2.525,2
255	KIMBERLY CLARK DE MÉXICO	Mexico	Pulp / Paper	1.666,5	1.967,8
263	BAVARIA	Colombia	Beverages	1.635,1	1.800,0
274	ARACRUZ CELULOSE	Brazil	Pulp / Paper	1.581,9	2.171,8
292	EMBOTELLADORAS ARCA	Mexico	Beverages	1.463,8	1.702,7
294	INDUSTRIAS BACHOCO	Mexico	Agroindustry	1.453,8	1.668,1
314	EMBOTELLADORA ANDINA	Chile	Beverages	1.346,8	1.284,1
321	KLABIN	Brazil	Pulp / Paper	1.325,0	1.578,8
326	AGROSUPER	Chile	Agroindustry	1.300,0	1.505,0
327	GRUPO VIZ	Mexico	Food	1.300,0	896,1
333	VOTORANTIM CELULOSE E PAPEL	Brazil	Pulp / Paper	1.279,8	1.812,8
344	CCU	Chile	Beverages	1.242,7	1.267,2
354	DANONE	Argentina	Food	1.200,0	1.044,3
358	ALICORP	Perú	Food	1.178,6	931,9
360	AURORA ALIMENTOS	Brazil	Food	1.143,1	1.138,9
372	IMCOPA	Brazil	Agroindustry	1.134,8	1.104,5
375	CMPC CELULOSA	Chile	Pulp / Paper	1.121,3	1.403,2
384	AJE GROUP	Perú	Beverages	1.090,0	858,3
416	GRUPO ANDRE MAGGI	Brazil	Agroindustry	1.007,7	1.005,0
419	GRUPO SCHINCARIOL	Brazil	Beverages	1.003,2	1.473,4
433	KRAFT FOODS	Brazil	Food	949,9	1.136,1
436	ALPURA	Mexico	Food	943,0	937,7
440	M. DIAS BRANCO	Brazil	Food	938,2	850,9
443	GRUPO CONTINENTAL	Mexico	Beverages	927,3	1.125,3
445	MINERVA	Brazil	Agroindustry	907,5	825,7
447	CAROZZI	Chile	Food	902,8	868,5
457	CARAMURU	Brazil	Food	845,9	731,3
459	ITAMBÉ	Brazil	Food	842,0	956,0
469	GRUPO GLORIA	Peru	Food	820,4	945,7
475	UCP BACKUS & JOHNSTON	Peru	Beverages	809,3	738,6
478	C. VALE	Brazil	Agroindustry	800,8	766,4
495	CORPORACIÓN DURANGO	Mexico	Pulp / Paper	750,8	748,7

Source: América Economía.

In summary, economic literature, international experience and businessman's opinion point out that there are clear net benefits to be reaped from FDI in MERCOSUR agribusiness. Among them, increase in productivity and wages, access to international markets, technological and managerial spillovers to local providers and competitors, are the most likely.

2. Risks and bottlenecks of agro-industrial investment projects in MERCOSUR

This section develops the analysis of the obstacles and bottlenecks to investment in each MERCOSUR country that affecting agroindustrial investors in general, could present modalities especially discouraging for the foreign ones.¹⁵ To present a relevant account of these obstacles in an orderly manner they are described according to their role in a typical investment project scheme as evaluated by the investors.

Our analysis will show that there are only very few aspects where foreign investors suffer from legal discrimination or face formal barriers to invest in MERCOSUR agro-industrial sector. Since the 90s, the modernization of the legal framework along with the search for an increasing international insertion resulted in an improved environment for FDI attraction to these countries.

However, the obstacles and risks to invest that affect these developing economies may affect foreign and domestic investors differentially, causing an inward flow of FDI lower than optimal. For instance, problems with land titles requiring judiciary intervention may entail different transaction costs for nationals as compared to foreigners due to specific knowledge about the procedures of the legal system (for instance, effective time for settlement is better appraised by domestic companies). Similarly, the strength of financial linkages that a given investor has in each country due to previous investments there turns out to be an important determinant of subsequent location decisions, and also a key factor in explaining the choice between investment at home and abroad (Mayer et al, 2010). According to the literature on FDI these differential transaction costs may partially explain the "home bias" in investment.¹⁶ Even though this bias is difficult to compensate, the attraction of FDI may be improved by reducing transaction costs to investment in general which will also benefit the economy as a whole.

From the economic point of view it is usually assumed that out of a number of k potential locations, a TNC will decide to invest where after-tax profits are higher compared to alternative locations. And, given the location decision, the TNC invests until the investment exactly earns the cost of capital. Under a broader view, it is also recognized that the FDI

¹⁵ Goodspeed et al (2006) have examined the impact of three host country government policies on the host's FDI stock: taxation, good governance, and infrastructure. Their results indicate that FDI is sensitive to host country taxation in developed countries, but not in developing countries; FDI is sensitive to host country corruption in developing countries but not developed; and FDI shows sensitivity to host country infrastructure quality in both developed and developing host countries, though FDI appears to be more sensitive in developing host countries.

¹⁶ The disadvantage of FDI in the host country due to incomplete knowledge of the business environment has been named as 'liability of foreignness'

decision-making process tends to emphasize strategic analysis along with (or over) financial analysis.

The process generally starts with an idea or a sketch of a project where the interest focuses in internationalization of the company's activity. A set of potential countries for exporting or investment location are considered. The sequence of decisions starts with the choice between exporting and FDI. In the case of FDI, the firm faces two options: greenfield investment or merger and acquisition (M&A). If it selects greenfield investment, it has two ownership choices: whole ownership or a joint venture.¹⁷¹⁸But capital investments are not risk free and assessing risk is an important part of the cost-benefit analysis. In practice, there exist a considerable variety of methods to proceed to this evaluation and evidence shows that risk assessment is often dealt separately from financial analysis.¹⁹ Moreover, due to strategic considerations, managers could be ready to accept any location presenting a political and economic risk lower than an acceptable threshold. Then financial considerations are introduced for each location and alternatives to provide risk management for each case are added.

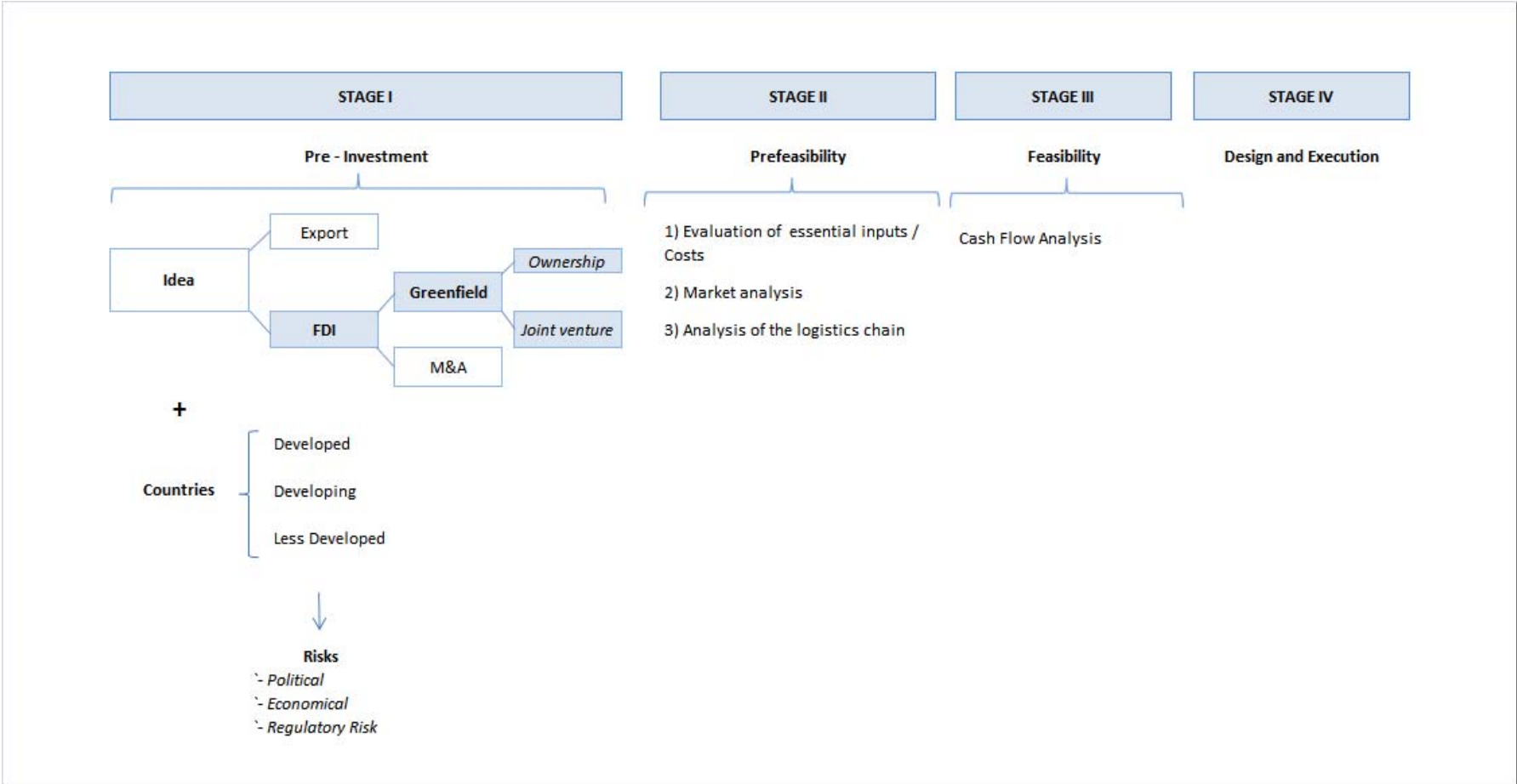
The following Figure describes the components of the typical decision making process and cash flow for FDIs.

¹⁷ Stahler et al (2007) verify this decision making sequence for Japanese companies operating in the 90s.

¹⁸ One straightforward way that companies use to reduce risk is by enrolling the participation of local partners and venture capital investors.

¹⁹ In theory, the discount rate entering the financial flows should be adjusted by a risk coefficient.

Figure 3
International investment project: main stages



Source: Own based on References.

2.1. Business Environment: Economic and Political Risk Assessment

The interest in developing countries as new locations for investment triggered systematic analysis on business environment and associated risks. During the 90s and 2000s, the trend towards business globalization created a demand for better information on country risks and many international consulting services plus multilateral and business organizations conducted surveys including a wide range of country risk and country performance indicators to help business decisions.²⁰ These data reflect both the effective economic and political performance and the perception of the business community on selected aspects of a country's operation. There is not a unique measure to everyone but, for instance, the available indicators such as the country risk premium in sovereign bonds, tends to represent the average investor's risk forbearance.

Cash flow methodologies generally evaluate investment projects including an upward adjustment of the discount rate to take risk into account, reducing the present value of future cash flows of risky projects. Other possible methods for assessing risky capital investments are simulation, sensitivity analysis and the use of game theory among the more sophisticated analyses.

Economic risk is often mentioned as connected to government macroeconomic mismanagement that can lead to higher inflation and higher interest rates. As a result, firms will face higher costs and planning difficulties. In the case of political risk companies find it to be an important element to their investment decision, but are often unable to express it numerically. In practice, this risk is considered during the first steps of the process and is expressed mainly qualitatively.

For investors, the nature of investment and risk varies along the agro-industrial value chain (including agriculture as the primary source, logistics, processing industry and the importance of retail distribution). The characteristics of size, specificity, investment duration, product cycle, etc, shape the investment in response to the opportunity, the market and its business climate. For governments, attraction of new investment, domestic or foreign, requires taking into account the nature of the business and the means to make apparent to the investor that planned returns of the investment will be accrued under a reasonable and foreseeable risk (See Box 2 for details)

²⁰ Among them the World Bank and UNCTAD, Unido and WTO are good examples of multilateral organizations involved in business climate analysis. The World Economic Forum is a case of entrepreneurial organization. There are also NGOs and University Centers providing a wide range of information.

Box 2: FDI in the agroindustrial value chain: the “hold-up” problem

Depending on the nature of the production process and characteristics of the product or service, required investment may exhibit different degrees of irreversibility and specificity. Due to that intrinsic exclusive value of “sunken” investments, ex-ante expected returns may differ from ex- post results. This fact leads to “endogenous uncertainty” for the investing company: once specific investments are made, one of the parties in the chain (i.e. suppliers) could refuse to trade unless more favorable conditions are granted to them or the government could behave “opportunistically”, confiscating part of the returns through new taxes or regulations. The investing company could hardly refuse to trade, given that capital is already sunk and there are not outside opportunities (or they are very costly).

Therefore, it is reasonable to think that “rational investors” will anticipate the hazards of this potential “hold-up” situation and refuse a contract that would put them under that asymmetrical power.

The first reaction is to find a way of self insurance. The most obvious is to reduce investments (under-investing with respect to the efficient level) or not to enter in a reciprocal trade that is asymmetric in terms of power. The need to avoid this kind of reaction is behind the recommendation for a stable “business climate” provided by proper enforcement and stability in the rule of law.

Alternatively, firms could restrict their investments to segments of the industry in which irreversible investment have small share in the total. This would help to acquire information, to learn more on the character of the relational contracts with suppliers and customers. Sunk investments will be therefore postponed to future stages. Typically, investments in upstream could have a higher degree of irreversibility than investments in downstream.

There are several shortcomings that could favor an underinvestment or no-investment decision:

- *The size of the project would require the involvement of many participants to spread risk.* Maybe the size of the economies is not big enough for diversification through risk spreading among many agents.
- *The project cannot be fragmented in physical smaller investments, or it cannot be extended in duration terms.* Guriev and Kvasov (2005) report empirical observations that link duration of contracts with specificity of investments. Hence, they propose to use a sequence of contracts that replace each other to give incentives for investments (when fragmentation is possible), instead of a unique long term contract.
- *It is not possible for an authority to sustain the effort to overcome the problems of lack of enforcement.* Due to institutional weakness, for example, it could be impossible to write and enforce contracts allowing the integration of suppliers along the value chain and under the same corporate governance. However, trade is observed even under these adverse circumstances. The literature explaining this fact includes the following ideas: 1) Repeated interaction creates incentives to cooperate rather than cheat. 2) Under those circumstances, contracts would be self enforcing. 3) People might cooperate due to internalized notions of reciprocity (this is a result observed in experimental economics). 4) Cooperation is difficult if groups have high discount rates, are too large or are too heterogeneous.
- *There are not other dimensions of negotiation.* If participants can negotiate on other issues, for example on trade flows or import taxes, some compensation could be found. For example, assume that country A is in position to exert power on country B in a hold up situation. But that country B is a critical importer of goods from A. Then there good be a clear threat that could help to solve the problem of hold up.

In broader terms, the problem of under-investment or lack of investment under hold-up is not easy to solve. The literature has proposed several solutions, some of them inspired by actual solutions observed in real contracts such as the allocation of property rights; the definition of rules that govern renegotiation; breach remedies; segmentation of investments, etc. In the case of FDI, several of these solutions are included in the regulating Laws.

Source: Own based on quoted bibliography, see the Reference section.

The following sub-sections present a synthesis of the more usual indicators taken into account by international investors for the MERCOSUR countries along with the opinions collected during

the interviews for this study. They will provide information on several pitfalls that have to be remedied in order to improve FDI attraction.²¹

2.1.1. Macroeconomic performance and tax burden

Overcoming a history of macroeconomic failures, most of LACs have improved their performance since the 90s, controlling inflation and resuming growth. The recent international crisis (2007-08) put the whole region under financial pressure but as a result of their enhanced macro situation, most of the countries showed a great resilience to the external shock and are recovering their growth impulse after a short negative cycle.

Table 7 shows the selected macroeconomic indicators for MERCOSUR countries as recorded in the 90s and 2000s. In each case the level and volatility of the variables are represented by the average and the measures of deviation and coefficient of variation.

Table 7

Macroeconomic environment Selected Indicators for risk assessment								
Indicators	Average				Coeff. Of Variation			
	ARG	BRZ	PY	UY	ARG	BRZ	PY	UY
<i>1990-1999</i>								
GDP Growth rate (% - GDP in PPP)	6,6	4,0	4,7	5,5	0,8	0,7	0,5	0,7
Inflation Rate (% annual)	254,0	855,0	16,0	49,0	2,9	1,3	0,6	0,7
Real Exchange Rate (annual depreciation rate %)	(16,0)	(6,0)	(3,0)	(9,0)	1,8	5,3	3,3	0,9
Country Risk Premium (EMBI – Basis Points) 1/	2.474,9	943,8	sd	570,0	1,0	0,2	sd	1,0
<i>2000-2009</i>								
GDP Growth rate (% - GDP in PPP)	5,7	5,7	4,8	5,1	1,4	0,4	0,9	1,2
Inflation Rate (% annual)	9,0	7,0	8,0	9,0	0,9	0,4	0,4	0,6
Real Exchange Rate (annual depreciation rate %)	17,0	3,0	2,0	6,0	3,1	8,0	9,0	3,7
Country Risk Premium (EMBI – Basis Points) 1/	1.789,0	330,5	sd	355,1	1,1	0,4	sd	0,4

Notes:

1/ Figures for 1990-1999 corresponds to 1998- 2003. Figures for 2000-2009 corresponds to 2004-2009.

Source: Own based on JP Morgan, IFS-IMF and WEO IMF.

²¹ Several international institutions such as FAO, UNIDO and the OECD coincide in pointing out that the experience of developing countries as regards FDI attraction to the agribusiness sector have faced risks and have often failed. Their analyses identified several key issues to be taken into account in order to design a successful strategy. Among them: correct risk perception of the sector development and potential by new investors; agility of specific institutions governing and regulating the domestic market and the exports such as sanitary and phytosanitary agencies, patent offices, food and drug regulators, etc; policy design and business horizon according to investment maturity. These issues compose specific entries in the list of characteristics that define a friendly business climate in any country for investors, foreign and domestic alike.

According to this information, the main aspects to be taken into account for the analysis are the following:

-Economic growth has been fairly steady in all the countries. However there are substantial differences in the volatility as measured by the “coefficient of variation” (the standard deviation as percentage of average rate of growth). Argentina shows the highest level of volatility and Brazil the lowest.

-High inflation rate is a highly negative factor when evaluating the performance of the economy. Macroeconomic instability is a major deterrent of investment and growth. At the microeconomic level, it affects both revenues and costs of the companies turning it difficult to evaluate the yields of a project. Price and exchange controls subject the information contained in prices to discretionary changes often reducing economic transparency.

In the 2000s most of Latin American countries improved their macro situation, reducing their inflation rates on sustainable basis. Brazil and Uruguay were outstanding cases. In the case of Argentina, figures show that improvements were made as compared to the historic performance but, unfortunately, inflation rate continues to be very high as judged by international standards.²²

In the case of Brazil, as from 1994, the inception of the Real Plan succeeded in controlling inflation. The country moved to a floating exchange rate system, adopted “inflation targeting” and improved fiscal results. Agribusiness was part of the solution along the macro stabilization process since it contributed to the accumulation of foreign currency reserves up to a level high enough to protect the country’s finance against external crisis.

Unfortunately, Argentina underwent a major economic crisis in 2001-02 and has not been able to fully recover yet in spite of achieving high economic growth in 2003-2008. Curbing inflation was still a pending matter at the beginning of 2010.

-Real interest rates are not necessarily a good indicator of the financial conditions that firms face in the market. In fact, low interest rates may be detrimental of new investment as they are compatible with a narrow market and rationed loans. For large, foreign and export-oriented corporations the domestic interest rate is not a good measure of credit availability. However, for smaller, domestic-market oriented firms the local cost of funds is relevant.

-The country-risk premium - as measured by the basis points that a yield of a sovereign bond must paid above a similar bond of the US Treasury²³ - is an approximate indicator of stringency of capital markets for firms located in a country. Having defaulted on its debt in 2001 and still with some international problems pending (debt regularization with the Paris Club), in early 2010 the Argentine Government had to pay 17% more than the US Government over new issued bonds. Brazil and Uruguay governments paid a country risk premium of approximately 3.5%.

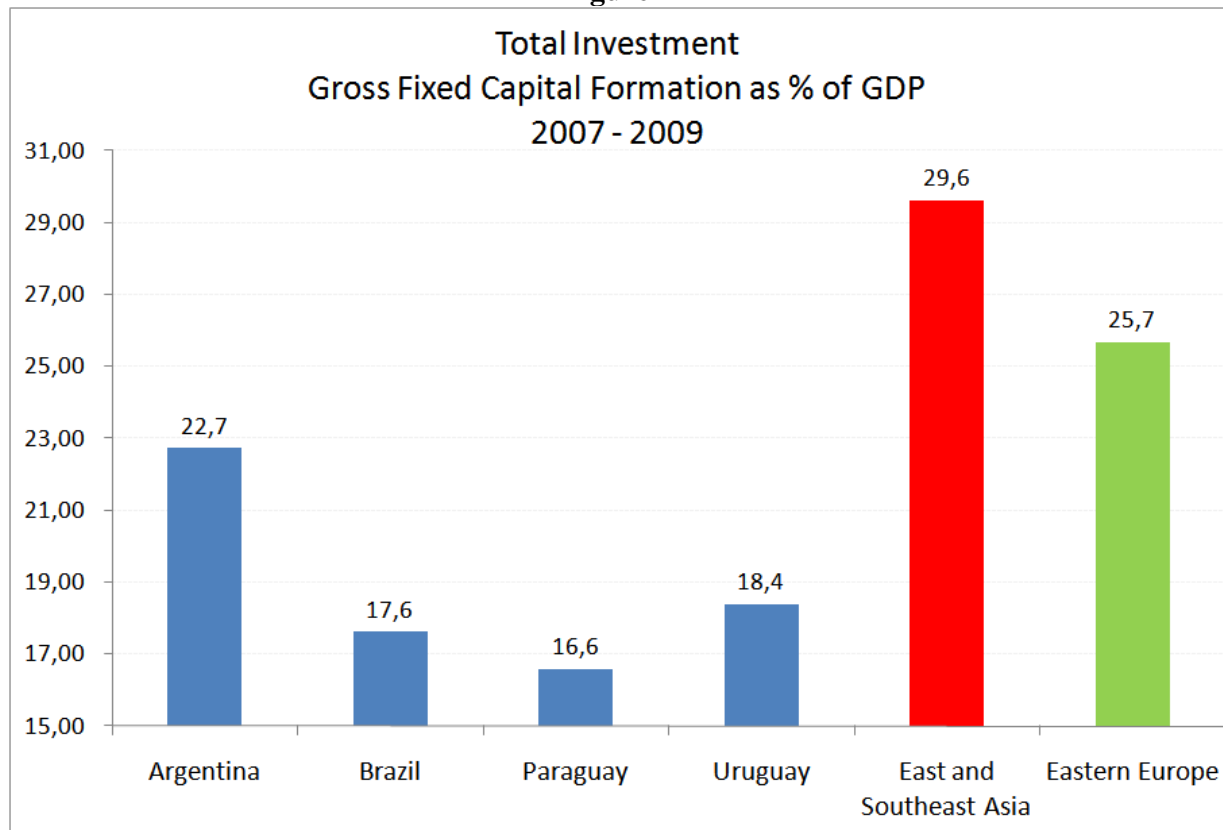
²² Persistent increases in prices have been a common feature to all MERCOSUR countries, particularly the largest ones. In fact, inflation rates were figures of three digits or even four until the end of the 80s in Argentina and Brazil. Historical volatility observed in these countries is also very high.

²³ The Emerging Markets Bond Index (EMBI) is calculated in this way by the J.P. Morgan bank.

-A higher country risk premium implies lower discounted cash flows for domestic companies or projects. Nevertheless, low valuation will attract FDI whenever the affiliated company can hedge against this country risk, for instance, borrowing from headquarters and transferring larger amounts of profits.

As a result of the unsatisfactory macroeconomic past performance, the rate of investment remained low for MERCOSUR countries when compared to other developing regions such as East Asia or Eastern Europe (see chart below). The cost of financing, the availability of domestic savings and a slow growth in productivity that reduces reinvesting capacity of already established companies are factors behind this result. Regarding these factors, macroeconomic instability has proved to be an important deterrent of FDI inflows to LAC and particularly to Brazil and Argentina in the past. In contrast, in a macroeconomic stable scenario FDI has shown a relative advantage to overcome high financing costs in the host markets as TNCs usually have access to international funding and are generally characterized by higher productivity.

Figure 4



Source: Own based on World Development Indicators. World Bank.

Tax burden and investment: a conflicting relationship.

One macroeconomic factor that has proved to be a key one in discouraging investment in general and FDI, in particular, is the excessive tax burden on new investment and on corporate revenues and profits.²⁴ Since the 90s, TNCs have actively engaged in “tax planning”²⁵ as a method to improve their global results and, more recently, there is some evidence that host countries have promoted tax reforms to compete for FDI attraction. However, given the tax burden in each country, domestic companies may be better equipped to exercise tax avoidance or be less visible to engage in informal activities, so reducing their tax burden. Moreover, tax planning is expensive for TNCs. Table 8 shows the current total and direct tax impositions to business in our countries. On top of them, there are many inefficiencies derived from higher than average incidence of the tax burden on the formal business²⁶ and distortive effects of sales and value added taxes, that being indirect (on consumption) in principle, cannot be fully transferred to consumers in practice.

Table 8

Tax Burden and Corporate Taxes 2008		
	Tax Burden (Tax Revenues as % of GDP) 1/	Corporate Income Tax (as % of GDP)
Argentina	31,8	3,6
Brazil	35,8	5,1
Paraguay	13,7	2,2
Uruguay	23,3	2,6
OECD Total	35,8	4,8

1/ Including Social Contributions
Source: based on ECLAC database and OECD Stats.

²⁴ Castelar Pinheiro et al (2010) find strong evidence that human capital as well as high and inefficient taxation are currently the most severe constraints to growth, for they significantly reduce the returns on investment and thus hold back growth. There is a second group of problems identified in our analysis as potentially strong constraints, which may become binding over time. This includes infrastructure (especially in electricity and transportation) and financing: domestic savings may be too low to sustain higher growth and may choke investment if access to international financial markets deteriorates.

²⁵ In the case of international companies, tax-planning includes: thin-capitalisation of high-taxed subsidiaries, “doubledip” financing (enabling interest deductions taken by both a parent company and a foreign subsidiary) and the use of hybrid securities in place of conventional debt, and the use of tax haven finance affiliates and hybrid entities to avoid home country corporate tax. (OECD, 2007)

²⁶ Average tax burden on GDP underestimates the real burden tax on formal business. International firms mostly engage in formal business relations, thus the burden tax they support is higher than the average one that is estimated as the total tax collection on GDP that includes formal and (partially) informal activities. In Argentina, FIEL(2006) estimated that while total tax burden on GDP was around 29% in average in 2005, the equivalent measure for formal companies was around 38%.

Notice, however, that this is not a valid argument to promote tax reliefs for FDI attraction. In fact, OECD (2007) states that in setting the tax burden on inbound investment, policy makers are encouraged to assess whether their host country offers attractive risk/return opportunities, taking into account framework conditions (e.g. political/monetary/fiscal stability; legal protection; public governance), market characteristics (market size, availability/cost of labor, energy, state of infrastructure) and the prevalence of location-specific profits. Since, host country framework conditions and market characteristics depend in part on past and current levels of public expenditures on programs in areas of critical importance to investors (e.g. infra-structure development), collecting tax to finance these programs is also a valid consideration to enter into the appraisal on the convenience of any tax reform. However this is a difficult signal to be monitor by TNCs when considering a prospect host country. Particularly, increases in the tax burden in MERCOSUR countries have not been directly connected to new infrastructure investment for agro-industry (see Infrastructure below)

Available literature shows a wide range of results regarding the sensitivity of FDI to tax burden. In general, the response is negative to tax rate increases²⁷ and investment involving large amounts of physical capital seem to be more responsive.

Recognition of the increasing tax competition between countries is apparent from the reduction of the statutory corporate income tax rate as a means to encourage FDI. Policy makers consider that this strategy entails various advantages: it is a relatively simple tax adjustment to introduce; readily observed by investors; efficiency improving when combined with base broadening; and able to reduce tax-planning pressure against the domestic tax base.

²⁷ Semi-elasticities measuring the percentage change in FDI in response to a 1 percentage point change in the tax rate are in the range of -5 and 0. (OECD,2007)

Box 3: Credit rating of Sovereign Debts

A bond is considered investment grade if its credit rating is BBB- or higher by Standard & Poor's or Baa3 or higher by Moody's, two well-known rating agencies. These agencies grade debt based on the sovereign government's capacity and willingness to honor all its debt obligations timely. A country rated as *investment grade* is considered to have a low level of risk associated to its assets and obtains better financing conditions due to lower funding costs. Investment grade status benefits not only the country's public sector by generating increased demand for government bonds, but also benefits its private sector, since sovereign ratings are used as a reference for private ratings.

The threshold between investment-grade and speculative-grade ratings has important market implications for issuers' borrowing costs. It was estimated that cost of capital decreases sharply when an issuer crosses the above mentioned threshold. Also, to be an investment grade country implies a certain degree of immunity to the crises in other emerging countries.

Brazil holds the "investment grade" category since 2008. Not many countries in the region hold this grade. In fact, only two countries out of the seven major Latin American countries were investment grade until 2007 (Chile and Mexico since 1992 and 2002, respectively). In 2008, other two countries joined this exclusive club, Brazil in April and Peru in July.

Argentina never reached such a rating for its sovereign debt. Uruguay, on the other hand, was rated as investment grade country between June 1997 and January 2002 when it was downgraded amid an economic crisis originated in Argentina.

South Africa also holds the investment grade since 2000.

Rating: Sovereign Debt Investment grade marked as *

Country	Standard & Poor's (1)		Moody's	
	Last change	Foreign currency rating LT/Outlook/ST	Rating (2)	Outlook
Argentina	Nov. 5, 2008	B-/Stable/C	B3	Stable
Brazil (*)	April 30, 2008	BBB-/Stable/A-3	Baa3	Positive
Paraguay	June 8, 2007	B/Stable/B	B3	Stable
Uruguay	July 22, 2008	BB-/Stable/B	Ba3	Stable
Chile (*)	Dec. 18, 2007	A+/Stable/A-1	A1	Positive
South Africa (*)	Nov. 11, 2008	BBB+/Negative/A-2	A3	Stable

(1) As of February 2010; (2) Moodys: Data as of January 19, 2010

Source: Own based on financial reports of Credit Rating companies.

2.1.2. Political and institutional risk assessment

Political risk is related to the fact that a sovereign host government may unexpectedly change “the rule of law” under which businesses operate. Changes in government policy and/or reform of political institutions could affect investment behavior of multinational corporations, as the risk premium incorporated in any investment project is influenced by political risk. The economic studies have identified the following relevant components of the institutional framework in developing countries that compound the political risk as perceived by foreign investors: government stability, internal and external conflicts, compliance with the rule of law, ethnic tensions, bureaucratic quality and, to a lesser degree, corruption and democratic accountability (Busse and Hefeker, 2007).

Norms and policies governing FDI inflows:

One first step for international investors as regards investment location consists in getting full information on the legal conditions governing their investments in the potential host country. In each country particular laws and norms for FDI may differ from the international *best practice* and the consequences of this departure from the general standard has to be well understood by foreign managers before the investment is decided. At the same time, investors will be interested in the stability of the norms and the compliance with the rule of law characterizing the host country.

In this study, a full comparison of norms and laws applied to FDI in MERCOSUR countries has been conducted and is presented in the Annex: FDI Norms and Policies. Here the main conclusions of this analysis are introduced in order to complete the elements of the risk assessment scenario.

The legal issues considered in the analysis are: degree of openness to FDI; national treatment; banned sectors; regulations on financial and labor contracts; registration requirements; dispute settlement; economic incentives and protection of property rights. The information used was based on the Laws and on the expert opinion of public officials and lawyers advising on FDI in each country (See Sources in References).

The *main findings* of the comparative analysis are the following:

- In general terms, the four countries under analysis are open to FDI. FDI and domestic investors are treated alike.
- However, there are restrictions to FDI in a few sectors, mainly in “Media and Communications” and “Mining”. Highly regulated sectors such as “Banking and Insurance” need government’s approval.
- There are no limits to foreign investment in land, except for areas close to the borders. In Uruguay since 2007 corporations purchasing land are required to use “registered shares” held by individuals (rather than bearer shares). This legislation caused foreign investors to put their plans on hold. Some large foreign companies were ultimately exempted from this requirement. Argentine Congress is considering a

bill to establish a cap on foreign land property.

- Fiscal incentives and State-funded programs are available to foreign investors and nationals alike.
- FDI access to any of these countries involves only a registration at the national authority level.
- Bilateral Investment Treaties for FDI protection have proved relatively unsuccessful in the Argentina case. Brazil has not used this kind of instrument until present.
- Foreign exchange transactions in Argentina must be registered and are subject to several restrictions.
- All the countries allow for international arbitration at some stage of their dispute settlement method. All MERCOSUR countries except Brazil are members of the International Center for Settlement of International Disputes (ICSID).
- Property protection is available in all these countries with different degrees of enforcement.
- Procurement is reserved to national capital in Brazil and Uruguay.

Even though the four countries present a similar leveled playing field, in practice they do not exhibit the same situation in terms of legal institutions and institutional arrangements to attract FDI. Brazil and Uruguay seem to be better positioned. Argentina though formally very near to the previous countries, exhibit several problems based back on the 2001-02 crisis that still have to be overcome. The full recovery of the institutional and legal arrangements is still pending. Paraguay shows a lower stage of institutional organization and means to respond to the challenge of attracting new flows of FDI.

In the Brazilian case, according to da Motta Veiga (2004) since the beginning of the strategy of ISI (Import Substitution Industrialization), Brazilian policies towards FDI were of a rather horizontal character (i.e. an across the board policy without strong discrimination among sectors) but, to some extent, restrictive in terms of “strategic activities” as was usual at the time. Most of the FDI flows were basically market-seeking driven due to the high protectionist trade barriers applied. The basic legal framework related to foreign investments remained stable over time despite the political instability that characterized Brazil between the 60’s and the 80’s.

After liberalization reforms in the 90s various limitations were reviewed. For instance, restrictions on IT (Information Technology) and financial sector investments to foreign companies and on outflows were lifted or relaxed. Also, the participation of private companies, no matter whether foreign or national owned, was allowed in the telecoms and in gas and oil areas. The latter change would enable foreign companies to participate in future biddings in public services concessions among other opportunities.

The Government of Brazil makes no discrimination between foreign and national capital since the beginning of the nineties. It actively encourages national and foreign investment in underdeveloped regions and in marginal areas. Registration requirements are kept according to the standards for any company, withstanding the source of capital. In case of conflicts with property titles or contracts, the Brazilian judicial system suffers delays and contract disputes may take a long period of time to move through the system. However, some judicial reforms undertaken in 2004 have eased some administrative procedures.

Argentina is also open to foreign capital. According to the Foreign Investment Law companies from abroad may invest in Argentina without registration or prior approval. Foreign capital is treated on the same bases as domestic capital. Foreign firms may participate in publicly funded research and development programs on a national treatment basis. Some regulations on exchange rate transactions are applied since 2002. In fact, inflows and outflows must be registered at the Central Bank. Argentine residents as well as institutional investors are restricted to net currency purchases up to US\$ 2 million per month.

After the 2001-02 macroeconomic crisis, the country adopted emergency measures that curtailed previous rights and created a sense of discretionary decisions that affected FDI relatively more due to the fact that any breach of contract and normative instability tends to be more costly to foreign investors.

The Government of Uruguay encourages FDI. There are neither restrictions nor discrimination toward foreign investment. In 1998, Uruguay enacted a law that declared that the promotion and protection of national and foreign investment is in the nation's best interest. The Law states that foreign and national investments be treated alike, investments are allowed without prior authorization or registration, the government will not prevent the establishment of investment in the country and, finally, investors may freely transfer abroad capital and profits from the investment.

Finally, the Government of Paraguay also guarantees equal treatment of foreign investors and there are no formal restrictions on foreign investment. Although private property is fully guaranteed in Paraguay, there were some episodes of expropriation of foreign-owned lands that were not compensated fairly. In fact, in 2005 the Congress approved the expropriation of a large area of land in Paraguay's Chaco region compensating landowners after lengthy negotiations.

Appraising political risk in MERCOSUR:

Political risk may be specific to the sector (for instance, land confiscation) or may affect the average market return on investments and through this mechanism, alter the rate of return of the specific project (e.g. an increase in corporate tax will reduce the average market return and the return of the agro-industrial project, as well).

Evaluating this kind of risks that might have effects on long term contracts is not an easy task because most of the related indicators are based on perceptions expressed by stakeholders (e.g. actual and potential investors, lawyers, economists, etc.). These risks may be hidden in confusing signals before some economic policy is announced. For example, confiscation of companies or

radical changes in taxes are not known in advanced but inferred from governmental precedents that generate the perception of an arbitrary power and the lack of the rule of law.

Interviews to stakeholders helped to build up an appraisal of the current situation of MERCOSUR countries, particularly regarding the agro-industrial sector.

In Argentina, most interviewees agreed that excessive tax burden and State intervention in markets (price controls, export prohibitions, etc) have created a negative climate for investors, domestic and international alike. The cases more often mentioned have been beef and wheat export bans; the imposition of heavy export taxes that ended up as confiscatory ones in the case of small and medium producers located far away from the main ports; price “administration” of natural gas, fuels and fertilizer prices, etc.²⁸

In Brazil, in contrast, the political risks were evaluated as very low but for particular investments. For instance, in the case of land acquisitions in recently developed areas the menace of land invasions or government interventions to distribute land among poor producers was mentioned as a moderate risk. A similar comment was present from businessmen of Paraguay.

Uruguay was reported by all the interviews as a safe investment location in terms of political risk.

To complete the panorama on political risks the following paragraphs present a synthesis of the international information available for MERCOSUR countries. (See Box 4 for details)

The institutional risk of MERCOSUR countries as reflected by the World Bank Governance Indicators may be summarized by the government effectiveness, the quality of the regulation and compliance with the rule of law. Table 9 shows the position of each MERCOSUR country where the score ranges from -2.5 (unsatisfactory) to 2.5 (satisfactory) with the highest position in the ranking being the best.

Comparison between 2008 and 1998 indicators show that Argentina has worsened in its ranking position. In fact, this country descended from the 70th percentile position in 1998 to the 48th in the last year regarding the regulatory quality. The same conclusion can be drawn when considering the government effectiveness (from the 62th to the 49th percentile) and the rule of law (from 57th to the 32nd percentile). No other country fell so dramatically. Analyzing the relative position in 2008, Uruguay was above Brazil except for the indicator of quality of regulation. Argentina and Paraguay were below these countries, the latter showing a better indicator of regulatory quality.

²⁸ Analyzing the political economy of the agro-industry in Argentina, Cristini et al (2009) pointed out that the possibility of collecting public revenues from the agro-industrial sector through extraordinary taxation, such as the export duties without facing strong opposition, might have developed confidence of the politicians in office over time on the availability of one secure source to finance their objectives and even their mistakes.

Table 9
Institutional and Governance Indicators

Year 2008						
	Government Effectiveness *		Regulatory Quality *		Rule of Law *	
	%Rank (1)	Est. (2)	%Rank (1)	Est. (2)	%Rank (1)	Est. (2)
Argentina	48.8	-0.2	28.0	-0.6	32.0	-0.6
Brazil	54.5	0.0	57.9	0.2	46.4	-0.3
Paraguay	22.2	-0.8	33.8	-0.5	15.3	-1.0
Uruguay	68.7	0.5	55.0	0.1	65.5	0.5
Year 1998						
	Government Effectiveness *		Regulatory Quality *		Rule of Law *	
	%Rank (1)	Est. (2)	%Rank (1)	Est. (2)	%Rank (1)	Est. (2)
Argentina	62.1	0.2	70.7	0.6	57.1	0.1
Brazil	54.5	-0.1	59.5	0.3	46.2	-0.3
Paraguay	16.1	-0.9	23.4	-0.7	18.1	-0.9
Uruguay	72.5	0.6	78.5	0.9	67.1	0.5

(1) Percentile position (2) Governance Score (-2.5 to +2.5) Higher values correspond to better governance.

BOX 4
Governance Indicators

The Worldwide Governance Indicators report aggregate and individual governance indicators for 212 countries and territories over the period 1996–2008. The aggregate indicators combine the views of a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. The individual data sources underlying the aggregate indicators are drawn from a diverse variety of survey institutes, think tanks, non-governmental organizations, and international organizations. They include six dimensions of governance:

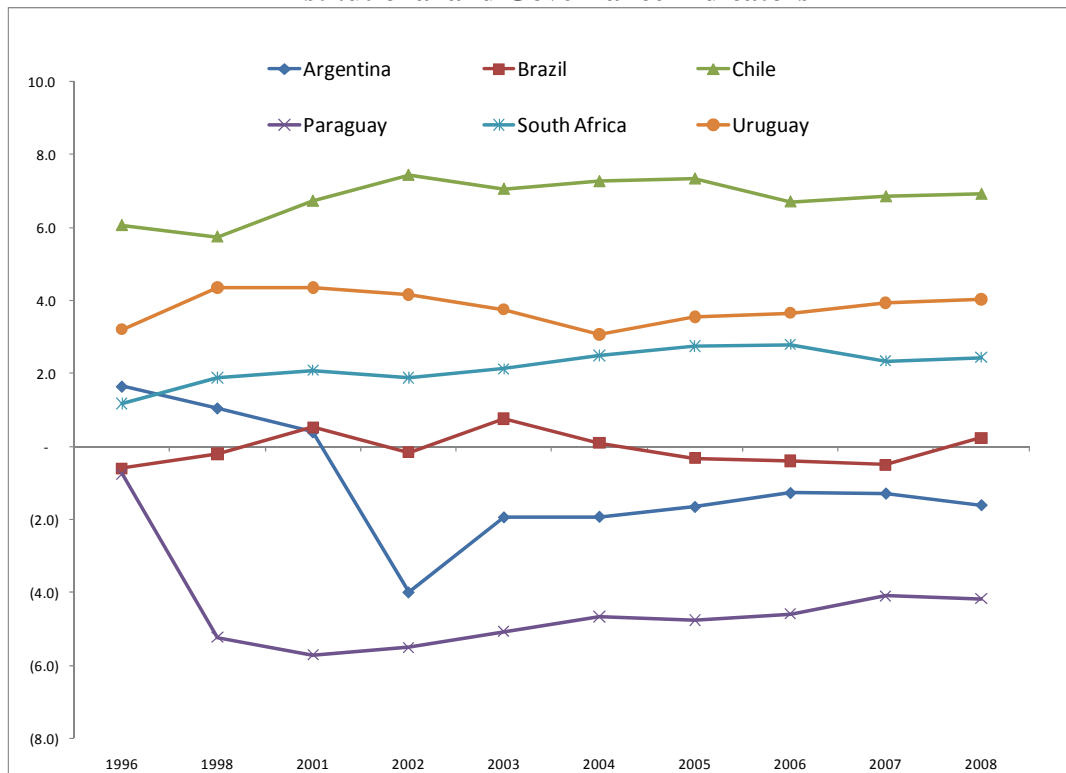
- *Voice and Accountability*: measures the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.
- *Political Stability and Absence of Violence*: measures the perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including domestic violence and terrorism.
- *Government Effectiveness*: measures the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
- *Regulatory Quality*: measures the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.
- *Rule of Law*: measures the extent to which agents have confidence in and abide by the rules of society, in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence.
- *Control of Corruption*: measures the extent to which public power is exercised for private gain, including petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

Source: <http://info.worldbank.org/governance/wgi/index.asp>.

Finally, Figure 5 shows the evolution of an average indicator of institutional quality and governance based on the previous ones. In this case, Chile and South Africa are used as

benchmarks. Chile is the country with the highest indicator implying the lowest political and economic risk. This country has also been improving slightly. South Africa ranks below but still above three members of MERCOSUR, with the exception of Uruguay. The latter displays a better performance than the rest since 1996. In the Argentine case the worsening of the political and economic environment as perceived by the business community brought about the decline of indicators locating this country below Brazil since the beginning of the century.

Figure 5
Institutional and Governance Indicators

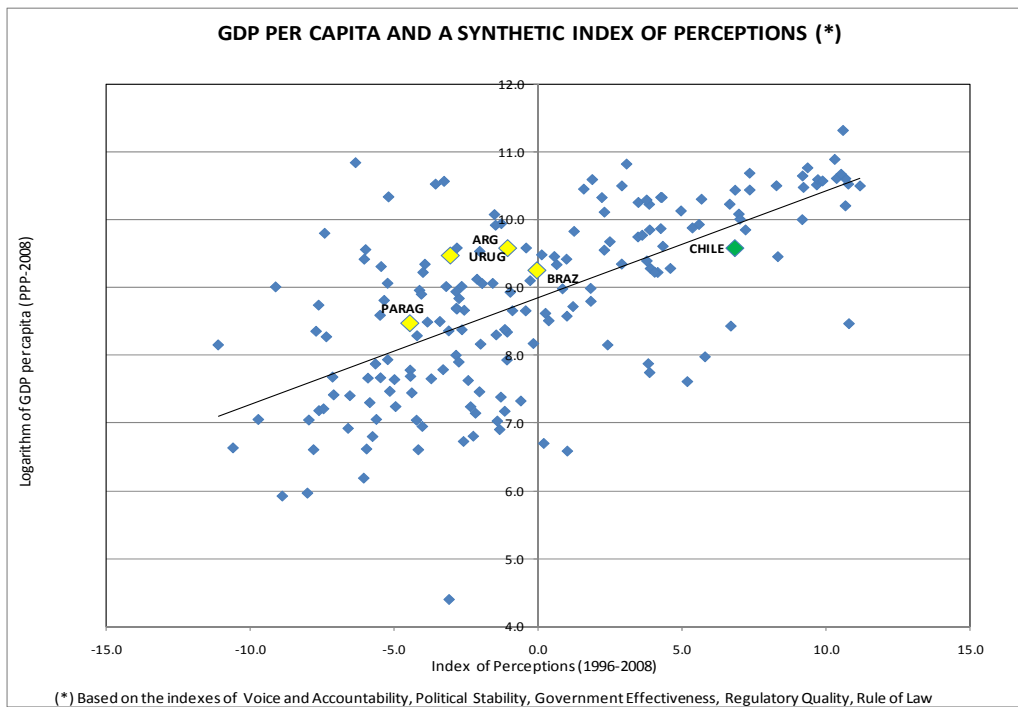


Source: Own based on World Bank Worldwide Governance Indicators

Which is the relationship between these indicators and the economic performance of the countries as measured by macro variables such as GDP level, investment and GDP volatility? All of them are closely linked. In fact, higher confiscatory risk, for instance, lowers investment especially in sectors with large sunk costs, conducting to a lower capacity of production and, through this channel, to a sluggish economic growth and to a lower disposable income.

Figure 6 shows the positive association between GDP per capita (welfare of the society) and the synthetic index for a group of 180 countries: the higher the indicator of perceptions the “wealthier” becomes the country. In the same vein, greater share of investment as percentage of GDP is associated to better perceptions and to lower GDP growth volatility.

Figure 6



Source: Own based on World Bank Worldwide Governance Indicators

Business environment and regulatory framework

In the 2000s, MERCOSUR countries increased their share of the State in the economy as compared to the 90s. In some chapters, such as infrastructure, this initiative was a response to an insufficient action in the past. Privatization of public services was very successful in many cases, but should not have meant that the State abandon its obligation of planning and investing in new infrastructure that was not being covered by the private sector.

In other chapters -including a wide range of production activities, market intervention to control prices or advancing in ownership of companies providing goods and services- the State initiatives are, usually, subject to serious drawbacks. From the point of view of private investors, the “entrepreneurial State” affects the market by competing for a desired pool of resources thus increasing investment costs. Moreover, when State intervention advances beyond judicious limits, the correlation coefficient between alternative economic activities increases. Under these circumstances, all these activities depend on a common critical factor: fiscal sustainability. Consequently, yields by sector “covariate” more than in a situation where only the private sector competes to provide goods and services in the market. This fact creates a paradox: the State intends to improve investment attraction by sharing risks as direct participant in the market and ends increasing the risk for investors due to the increase in the covariance between activities. The rational response of the investors is to reduce the level of investment of increasingly risky activities.

In Argentina, after the 2001-2002 crisis, and particularly since 2003, a new interventionist stance increasingly developed, either after the termination of previous concession contracts (as with the postal service, various water and train operations, etc.), the promotion of local investors with close ties to the government (in the telecom sector, transportation of electricity, and more recently, in the production of petroleum and natural gas), and the direct control of investments through specific funds and subsidies managed by the state.

In Brazil, a much more subtle participation in the economy through companies' capitalization by public banks has a potential to erase the borders between public and private responsibility in selected activities.

Finally, along with main political and economic risks, new projects may also face obstacles and barriers to doing business. This type of barriers can be considered an over-cost taxing the activity and has also been object of study and compilation internationally.

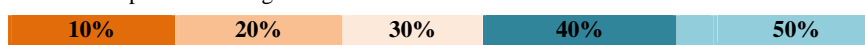
During the interviews this aspect was considered as a relevant one by businessmen and, in coincidence, several public officials in each country reported their efforts to reduce costs of doing business. This was the case of Paraguay. In Brazil, opinions coincided in the excessive bureaucratic burden existing for any transaction in the economy.

Table 10 shows the World Bank indicators by item of interest for the four countries under study. Notice that our countries rank below the median of the average of 181 countries in the world. In comparison, Chile and South Africa, which have been selected for benchmarking in our analysis, are well above that median. In the item of "protecting investors" Argentina is the worst positioned of the four countries. (For details on each indicator see ANNEX: Doing Business in MERCOSUR)

Table 10
RANKING OF EASE OF DOING BUSINESS BY TYPE OF PROCESS
Position out of 181 countries -2009

Ease of...	Argentina	Brazil	Uruguay	Paraguay	Chile	Sudafrica
Doing Business	113	125	109	115	40	32
Starting a Business	135	127	120	82	55	47
Dealing with Construction Permits	167	108	139	96	62	48
Employing Workers	130	121	79	177	74	102
Registering Property	95	111	149	70	39	87
Getting Credit	59	84	43	68	68	2
Protecting Investors	104	70	88	53	38	9
Paying Taxes	134	145	167	102	41	23
Trading Across Borders	106	92	127	138	53	147
Enforcing Contracts	45	100	99	103	65	82
Closing a Business	83	127	44	116	112	73

Note: Lower numbers mean the easier to do business. Source: Doing Business Survey, World Bank. 2009.
In the worst position among the 181 countries:



Prospects of political and economic risks in the agro-industry sector of MERCOSUR

Improved international insertion of MERCOSUR countries beginning in the 90s allowed them to acquire technology, reduce import costs of strategic inputs and attract investment to the infrastructure service. On return, competitiveness of the agricultural and food sector was enhanced and prospects for growth resumed, signaling the region as one of the most interesting locations for agroindustry international investors.

The evidence presented in the sections above described economic, political and regulatory risk as perceived by businessmen in these countries as compared to the rest of the world. In this analysis Brazil surged as a moderate risk country with bureaucratic over-costs. Uruguay ranked only slightly below, mainly due to its lower maneuver capacity being a small country next to influencing neighbors. Paraguay was recognized as suffering from historical ill-organized institutions, negatively affected by the condition of landlocked country. Risk is perceived as high but efforts to make improvements have been underway for a while. Finally, Argentina exhibits a history of important economic and political risks that reflects in the perception of international investors. Very important efforts will have to be done in order to overcome this situation.

2.2. Identification of main bottlenecks

Cost-benefit analysis of any investment takes into account the obstacles/advantages that are particular to each sector in each country.

In order to identify the main bottlenecks and obstacles in the region, interviews and market information were used to establish priorities and to collect further information for each cost item related to our stylized agricultural project (Figure 2 above). Additionally, agricultural cost structures were compared when available, to shed light on possible over-costs and inefficiency sources. For instance, Table 11 shows a comparison of costs for soybean, the most important agricultural production for Brazil and Argentina, using USA costs as a benchmark. Notice that Argentine total costs are 30% lower due to natural comparative advantage reflected in low land rent and in a technological package less intensive in fertilizers. Transport costs are similar in share but lower in absolute terms to US ones due to shorter distance to port in Argentina. Instead labor and machinery costs are noticeably higher. The case of Brazil is different since total costs are around 10% higher than US ones even when land rent represents only a very small fraction of total costs. Fertilizers and agrochemicals exhibit a very large share. Transport costs are also higher. Notice that comparison between total costs may be influenced by bilateral real exchange rates. In particular, Argentina may exaggerate its advantage through a depreciated rate and Brazil may lose part of it due to an appreciated exchange rate.

Table 11

Soybean production costs in selected countries 2005/2006			
As a % of total costs			
Cost item	Argentina	Brazil	United States
Land Rent	38,3	9,0	41,4
Labour and machinery	23,9	24,0	13,4
Seeds	8,0	4,6	10,2
Agrochemicals	8,4	22,3	8,3
Fertilizers	5,1	23,2	10,3
Total Farm Gate	83,6	83,1	83,6
Internal Freight	15,0	14,1	15,1
Port Cost	1,3	2,8	1,3
Total	100,0	100,0	100,0
Total costs compared	72,0	109,3	100,0

Source: Own based on Gutman and Lavarello (2006).

The following sub-sections present an account of the relevant information on advantages, obstacles and bottlenecks in agro-industrial investment projects.

- **Land and water availability**

The recent food crisis that dusted off the ideas on national food security also called for appraisals on the capacity to expand food supply in the world. Expert analysis has shown that increases in agricultural production are feasible in the near future. Both the adoption of new and improved technologies and the expansion of agricultural land will be the main means for this increase.

In the MERCOSUR case, all four member-countries are widely recognized by their comparative advantage in land resources. Currently, use of land in our region shows a trend towards an increase in the share devoted to crop as compared to cattle and the expansion of agricultural land frontier when possible. Table 12 reproduces the figures of land use according to the most recent agricultural census for our four countries.

Table 12

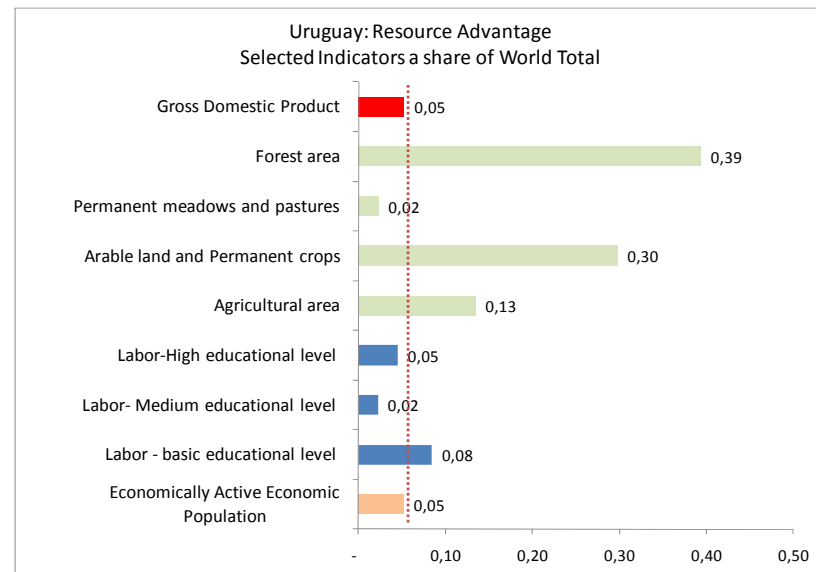
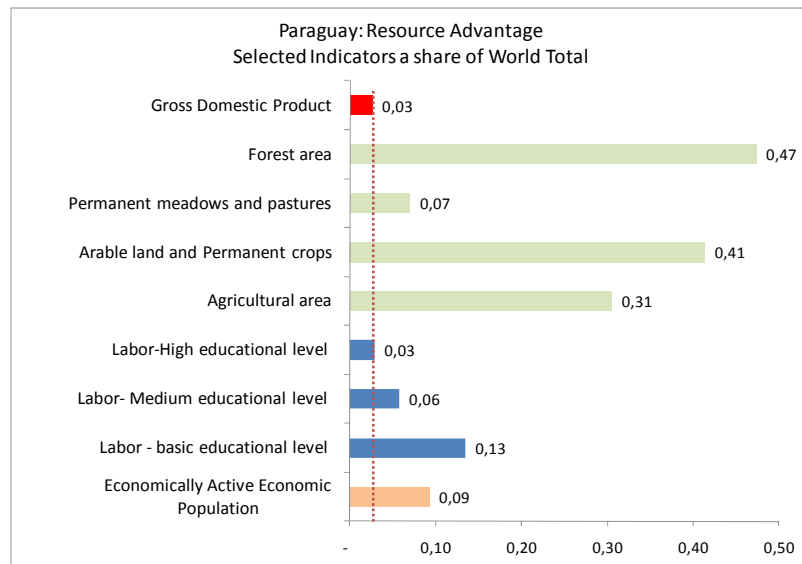
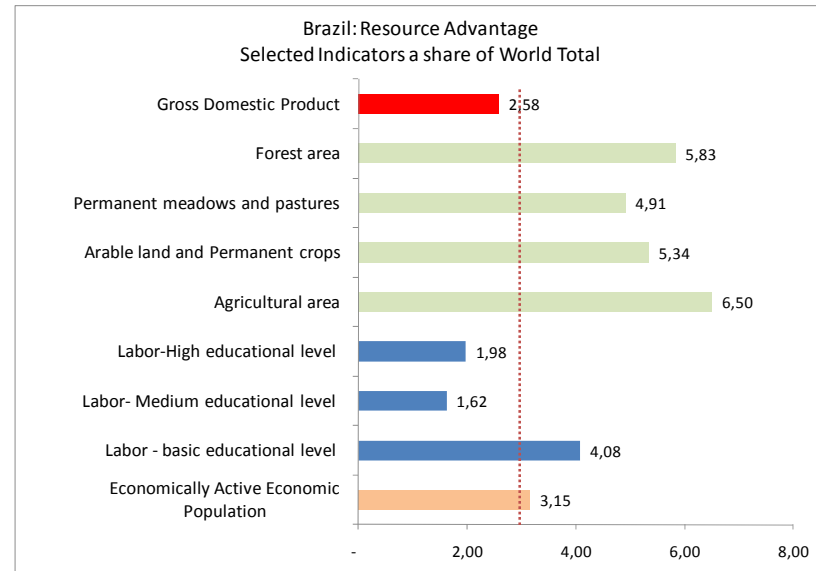
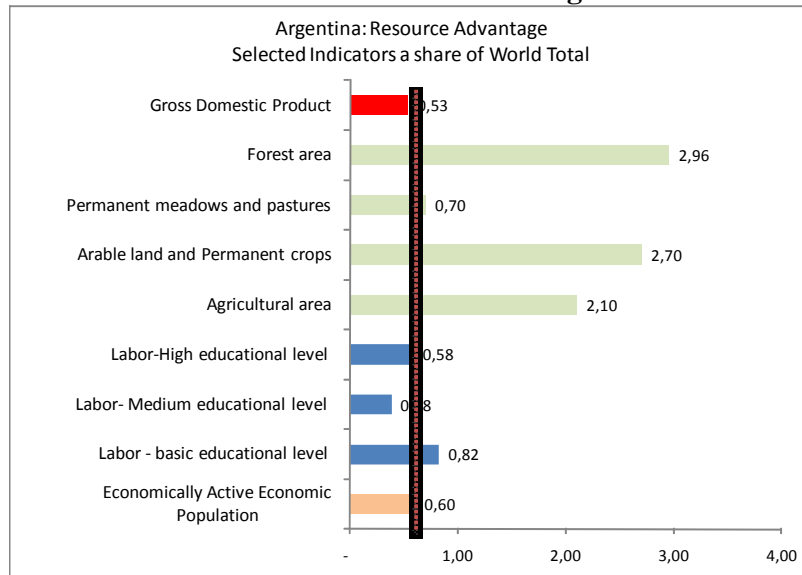
Land Use Area in 1000 ha.				
Land Use	Argentina 1/	Brazil 2/	Paraguay 3/	Uruguay 4/
Total	164.105	329.942	31.087	16.420
Permanent and Temporary Crops	20.338	59.847	3.365	2.544
Natural and Planted Pastures	103.855	158.754	17.838	12.927
Natural and Planted Forest	35.396	98.480	7.477	949
Other uses	4.515	12.861	2.407	sd

1/ Based on Agricultural Census 2002. INDEC.
2/ Based on Agricultural Census 2006. IBGE.
3/ Based on CAN 2008. MAG.
4/ Based on Agricultural Census 2000. MGAP.

To assess the importance of land stocks, they should be referred to the rest of the world and moreover, to measure the agricultural comparative advantage of MERCOSUR countries this reference should be evaluated against the share of national GDPs in the GDP of the world. Whenever the share of the resource stock on the world stock exceeds the share of its GDP on the world GDP, it can be considered that the country holds a comparative advantage in productions that use the resource intensively.²⁹ The following charts present the estimates of the comparative advantage indicators for land and labor.

²⁹ This is a classical indicator for comparative advantage introduced in Sources of international comparative advantage : Edward E. Leamer, (The MIT Press, Cambridge, 1984)

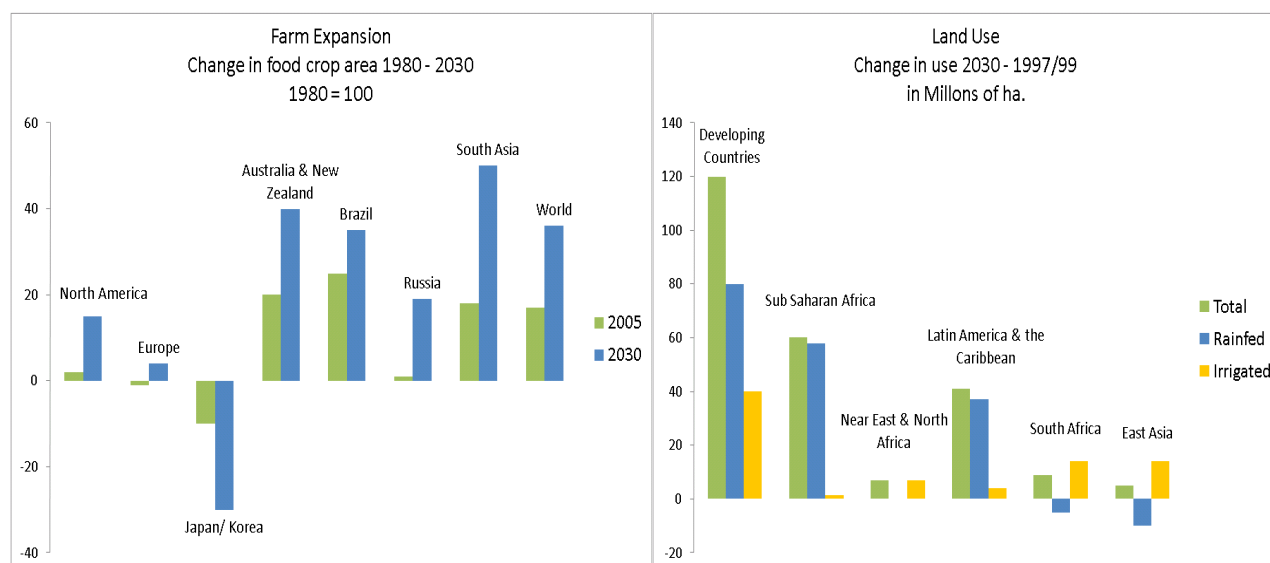
Figure 5- Source: Own based on World Bank and FAO



FAO (2002) assessed the prospects of the three main sources of growth in crop production: expanding the land area, increasing the frequency with which it is cropped (often through irrigation), and boosting yields. At the global level the report is confident in the ability of the agricultural system to supply the needed food in the future (prospects are presented for 2015 and 2030). In their view, “a comparison of soils, terrains and climates with the needs of major crops suggests that an extra 2.8 billion ha. are suitable in varying degrees for the rainfed production of arable and permanent crops. This is almost twice as much as is currently farmed. However, only a fraction of this extra land is realistically available for agricultural expansion in the foreseeable future, as much is needed to preserve forest cover and to support infrastructural development”. More than half the land that could be opened up is in just seven countries of tropical Latin America and sub-Saharan Africa.

It has been estimated that in MERCOSUR countries growth of agricultural production will entail an expansion and intensification in the use of crop and livestock farmland. According to FAO, uruguayan cropland only increased by 10% in the last 20 years. Brazil and Argentina’s increases were higher, around 20% while in the case of Paraguay, cropland almost duplicated from 1988 to 2008. Even though forecasts are subject to discussion, the following charts reproduced FAO and OECD recent estimates pointing to LAC and Brazil as key sources of agricultural land expansion.

Figure 6



Source: FAO and OECD

In the case of Uruguay, this country presents reduced dimensions as compared to the major partners of MERCOSUR, Brazil and Argentina, however private estimations point out to a potential incorporation to agricultural production of 2 million ha. in the near future.³⁰

³⁰ They are main partners in ADP that carries on investments in agriculture and feedlot in Uruguay along with software development that is transferred to the rest of the group companies in Brazil, Argentina and Uruguay.

As regards water, FAO studies suggest a total irrigation potential of some 402 million ha in developing countries, of which only half is currently in use. Once again, LAC and Brazil, in particular, will be main actors of this expansion.

Finally, yield growth will continue to be the dominant factor underlying increases in crop production in the future.

Arable land and water are often mentioned as recent attraction factors of FDI to the agricultural sector. During the 2007-08 peak of prices in international food commodity markets, the idea of “farmland grab” was discussed by international media and arouse the concerns of environmental organizations. The acquisition of new land included new actors from consumer countries such as China and Arabian Nations. Those countries bought land in many African countries invoking food security reasons. International organizations such as FAO alerted against abuses. According to UNCTAD (2009) foreign direct investment flows in agriculture jumped to USD 3000 million annually in the 2005-07 period, up from USD 600 million during the 90s. However, FDI flows in agriculture remain very limited when compared with overall flows. This increase mainly involved new south-south flows.

One risk perceived by international and large domestic investors refers to land reform policy. As it was above-mentioned, this issue was explicitly mentioned during interviews in Paraguay and Brazil. In both countries analysts³¹ point out that the number of potential beneficiaries keeps growing as poor rural and urban households with little or no farming experience, expect to be granted a tract of land. This fact has environmental implications as land distribution in certain areas (close to the Amazonas in Brazil and in the northern region of Paraguay) has contributed to deforestation. Interviews held in Paraguay and Brazil involved comments on the pending problem of agrarian reform in the two countries. The case of Paraguay has been already commented (See *Norms and Policies governing FDI*, above). In the case of Brazil, land reform and family farming have been a priority of agricultural policy since mid-90s. For instance, under the Cardoso administration, approximately 500.000 new family farms were settled in expropriated land.

The available agricultural census allow for a quick view to this aspect of land distribution (See Figures below). Paraguay and Brazil are the most unevenly distributed. In Paraguay, around 90% of producers own less than 8% of total lands and are organized in very small farms, under 100 has. A slightly different picture appears in Brazil where small producers own 24% of the land. In Argentina and Uruguay, around 60% of producers are very small. In contrast with the idea of land redistribution, the current development of the agricultural markets charges these small producers and the potential ones with the problem of sustainability. In fact, when compared to international standards the medium sized farm in MERCOSUR countries tends to be small. This situation changes the axis of the discussion from land ownership (improving distribution but jeopardizing sustainability) to the need of achieving sustainability for small producers through new production and marketing arrangements (cooperatives, associations, etc)

³¹ Interviews held with farmers organizations in Paraguay and with analysts in Brazil. Interview to Prof. G. Barros, Center for Advanced Studies on Applied Economics at Sao Paulo University reproduced in www.cobank.com, August 2009. Under the Paraguayan Constitution, large estates not being used are to be expropriated for the purpose of agrarian reform. Expropriations are determined on a case-by-case basis.

Figure 8

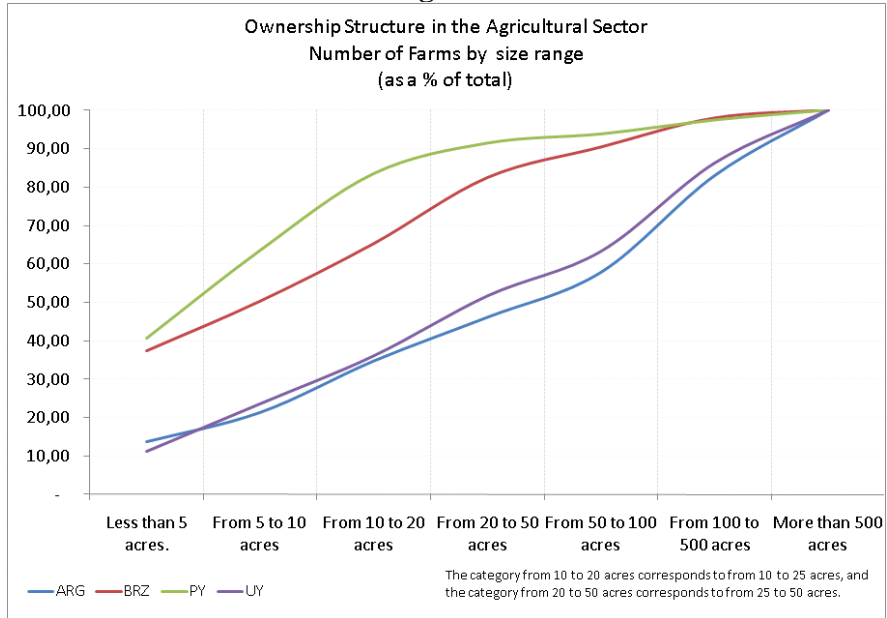
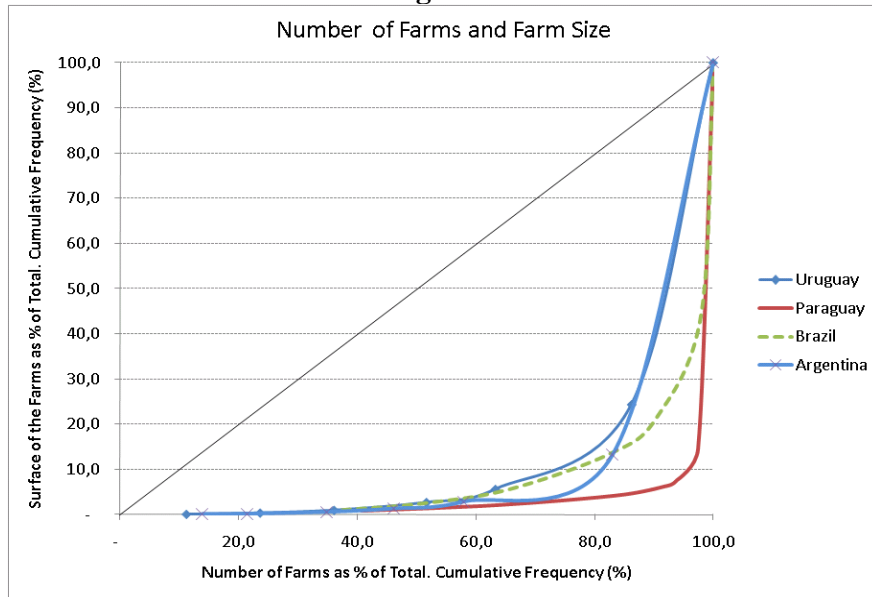


Figure 9



Source: Own based in Agricultural Census 2002 Indec, Argentina; 2006 IBGE, Brazil; 2008 MAG, Uruguay; 2000 MGAP, Paraguay.

MERCOSUR countries have into effect several laws to protect the environment in rural areas. In the case of natural forests, for instance, Paraguay implemented Law No. 422/73 on the management and exploitation of native and planted forests. It requires owners of over 20 hectares to leave 25 per cent as native forest reserves.

In the case of Brazil, in response to growing environmental threats and to environmentalist protests, the Brazilian Oilseed Processors Association (ABIOVE) agreed in 2006 to stop trading soybean produced on newly deforested areas.³² While the agreement may be hard to enforce it is also complemented by the authorities initiatives to exercise control on the compliance with the existing laws.

- **Labor and skills**

TNCs often choose production locations based on labor costs. However, in the case of US investors in the food-processing sector of developing countries, relative wages have proved not to be a critical factor in determining investment abroad.

The shares reported in Figure 5 illustrate the advantages of each country in our regional trade agreement regarding labor and labor skills. Brazil and Paraguay show a clear comparative advantage in unskilled labor and Argentina shows only a very moderate comparative advantage in skilled labor.

The interviews shed light on the expectations of investors in this item. Paraguay was referred as the country exhibiting more difficulties regarding the lows skills of the labor force. In Brazil this obstacle was also mentioned for specific regions and tasks. In Argentina and Uruguay, shortage of labor was reported for specific (technical) skills. Argentina was pointed out as a being affected by frequent labor conflicts.

- **Capital Investment and financing**

Because multinational corporations enjoy access to world capital markets, they may have an advantage over purely domestic firms when investing in activities that are capital intensive. However, lower costs of funding have to be match with higher risks in developing countries, what limits the contribution FDI can make in this chapter. In fact, during the recent international crisis many multinational agribusiness companies in Brazil and Argentina reduced their exposure in developing countries including MERCOSUR ones, and repatriated their capital reserves, thereby cutting a source of commercial credit to farmers.

At the same time, only a few commercial banks are ready to accompany the agribusiness sector development at the needed scale in the region. Heavily indebted small and medium producers in Brazil and Argentina have been a usual feature of this sector and the presence of public banks has not helped to solve the problem.³³

Notably during the interviews various affiliates of foreign companies indicated their demand for a fluid domestic credit market.

- **Technology adoption**

³² Cattle ranchers are also a very important threat to forests in Brazil.

³³ It is very likely that recurrent renegotiations of loans have discouraged private banks from crowding in the Argentine case.

On the one hand, FDI plays a very important role in providing developing economies with new technologies. At the same time, public research plays a similar role in the supply of certain categories of technologies (public goods) to the agro-industrial sector. On the other hand, technology adoption and diffusion is very dynamic in agricultural production and recently, the development of biotechnology introduced a true revolution in agricultural performance. International companies specialized in seeds and agrochemicals have come to the forefront of the agro-industrial chain expanding their investment and influence. New regulations on adoption of biotech novelties keep being issued and disagreements on the scope of biotechnology in agricultural production are usual in the international arena.

Argentina, Brazil and Uruguay have a long-lasting tradition in public research devoted to the agricultural sector.

The National Institute for Agricultural Technology has been in operation in Argentina since the 50s, exhibiting an outstanding performance.

Leadership in tropical technology is one of the assets in the Brazilian case. Technological policy is recognized as having generated very good results in terms of farm productivity. EMBRAPA a state network of 41 centres located around the country is the main source of agricultural knowledge and technology. Among their contributions, it can be mentioned the technique of inoculating bacteria into soybeans to achieve nitrogen fixation from the air benefitting yields and the environment. Biological fixation of nitrogen is also being used in sugarcane production.

According to Chaddad and Jank(2006), the technologies that made the expansion into the *cerrado* region in the Brazilian Central-West- in soils that are distinctly inferior to those in Argentina and Southern Brazil, resulted from public investments in agricultural research. The average annual growth rate of total factor productivity in Brazilian agriculture was estimated at 3.3% for the period 1975-2002 and at 5,7% between 1998 and 2002.

Until recently in Brazil, investors in the agricultural sector faced uncertainties regarding the regulatory framework of research and marketing of genetically modified organisms (GMOs), and the reemergence of foot and mouth disease in cattle led to more than 50 countries to close their borders to beef exports from Brazil. Until very recently, GMOs adoption in Argentina has strictly followed the pace of approvals by EU, its main customer.

One distinct characteristic of Argentina's agricultural technology, shared with Brazil is the adoption of direct tillage. Environmental benefits from this regional agricultural technological pattern are to play a role in the international on going discussions on climate change.

- **Market size**

A larger market size, better prospects for market growth, higher degree of development, and higher per capita GDP growth are factors taken into account by investors when considering the location between alternative foreign countries.

As it has been already mentioned, in the case of Brazil, the macroeconomic stabilization following the Real Plan, boosted consumption and particularly, diversified food demand towards products with more value added. This fact accelerated the change in the consumption pattern that was already in progress due to rapid urbanization of the country. Urban population jumped from 68% to 82% between 1980 and 2000. In the case of Argentina, sharp economic fluctuations along with a low population size created a limit to the domestic market, shifting the interest of international companies to exporting projects, particularly those oriented to the region. A similar interest corresponds to the Uruguay and Paraguay markets that are small economies in terms of domestic market.

Table 13

Market Size						
MERCOSUR partners, Latin America and the Caribbean and World						
	GDP (USD Billions)		GDP per capita (USD)		Real GDP Growth 2003 - 2009 (annual %)	
	2003	2009	2003	2009	Total GDP	Per capita GDP
Argentina	127,6	301,3	3.370,6	7.508,1	6,5	5,5
Brazil	552,2	1.481,5	3.085,4	7.737,3	3,8	2,6
Paraguay	5,6	13,6	988,6	2.168,4	3,2	1,3
Uruguay	12,1	31,6	3.652,2	9.448,7	5,5	5,3
LAC	1.879,9	3.868,7	3.595,7	6.859,6	4,6	3,0
World	37.301,2	57.209,7	5.976,6	8.488,8	5,2	4,0

Source: Own based on WEO - IMF.

- **Strategic inputs: fertilizers**

The fertilizer international market is undergoing important changes. On the demand side, the production of ethanol from corn in USA increased the demand for nitrogenated fertilizers. At the same time, US imports are growing due to reduced competitiveness of its own plants.³⁴ Also, in the developing world the use of fertilizers is increasing rapidly due to food security reasons. The peak of food prices in 2007-08 increased the pressure on the fertilizer market at the same time that both higher transport costs and negative effects of market speculation were also present. As a result international prices of fertilizer increased very fast and availability was compromised³⁵.

In the international market, for instance, 40% of phosphate based fertilizers are concentrated in a few companies owing both the mining facilities and the processing: Mosaic (USA,14,4%); OCP (Marroco, 8,3%); PCS (Canada,6%); PhosAgro (Russia,4%); CGT (Tunisia, 3,6%), Foskor (South Africa, 2,5% and Eurochem (Russia, 2,5%). These companies and several others are very active in searching for new locations for investment to expand their activities through mergers and acquisitions. Capacity expansion is also being undertaken in nitrogen based fertilizers. In this case the availability of natural gas at competitive prices is the main driver of the decision.

³⁴ In part, current shortage is explained by underinvestment by international companies over years of very low profitability.

³⁵ Nitrogen, phosphorus and potassium are the three basic elements for fertilizer production.

Argentina and Brazil manufacture, import and export (mainly Argentina) fertilizers for agricultural production. Agricultural expansion will imply a parallel expansion of agrochemical industry in MERCOSUR region.

In the case of fertilizers in Argentina, new demand of urea and phosphate fertilizers is expected to be provided by expansion of local production. The most important obstacle reported by the sector representatives is that natural gas production has been subject to various policy distortions lately (regulation of natural gas price and price orientation in the case of nitrogen based fertilizers) jeopardizing the interest of international companies in new investments. Exports to Brazil, Uruguay and Paraguay were given priority due to better prices as compared to “oriented” local ones.³⁶

International companies have a long tradition in the Brazilian fertilizer market, oriented to provision through local production and imports.³⁷ Demand growth remained ahead of supply and Brazil is currently very dependent of imports. Growth expansion in recent years led to a growth in demand, with a strong impact on prices.³⁸ Brazil is the world’s fourth largest consumer of fertilizers. Two thirds of fertilizer used in Brazil is imported. The expansion of farmland to the “cerrado”, a vast central grassland region in the center of the country, will demand plenty of fertilizer, especially potassium. One of the most important players in this market is Vale do Rio Doce, which has recently announced an agreement with the Bunge Group to acquire its fertilizer assets in Brazil, comprising phosphate mines and production plants of fertilizers based in phosphorus and nitrogen and Bunge’s stake in Fosfertil. This acquisition is considered strategic for the company that has already expanded in Argentina and Peru, in view of the expected expansion of Brazil’s agricultural frontier and the increase in the use of fertilizers per harvested area, the is still low compared to other countries of the region.³⁹

In the Brazilian case fertilizers are a focus of attention due to the importance of future demand and the relevance of imports in the case of potassium fertilizer. In opinion of ANDA (the Brazilian Fertilizer Industry Association), Brazil needs to encourage the efficient use of mineral fertilizers and liming materials that are technologically indispensable for increasing agricultural production in an environmentally sustainable manner. One source of concern is the country’s great dependence in the near future, upon the importation of both the raw materials needed to manufacture these mineral fertilizers and the final fertilizer products themselves. They consider that new initiatives are needed to fill this gap. The following are some of the most important for this study: intensification of mineral prospecting to evaluate Brazilian reserves of fertilizer raw materials; speed up processes at the final research report and extraction request phases for mining concessions; dissemination and implementation of FBMP (Fertilizer Best Management

³⁶ Market information and www.fertilizando.com.

³⁷ As of 1938 Bunge created a company to exploit and industrialize newly discovered phosphorus reserves in Cajati, Sao Paulo that finally became Bunge Fertilizers.

³⁸ The Secretariat of Strategic Affairs has proposed to reduce the tax rate of the value added interstate tax (ICMS) on fertilizers temporarily and to establish a state-owned, closed capital company (Fertilizantes do Brasil S.A.-FEBRASA) to produce locally.

³⁹ This acquisition matches Vale’s strategic goal of becoming a global leader in the fertilizer industry. Expanding its business into the fertilizer industry has been one of Vale’s strategic priorities, as reflected by the acquisition of the potash assets from Rio Tinto in February 2009.

Practices); intensify the implementation of crop rotation with biological nitrogen fixing plants; intensify research aimed at increasing the agricultural efficiency of conventional fertilizers (focusing on fertilizer production technology and agronomic efficiency).

Demand and price fluctuations in fertilizer markets create risks that are conveniently hedged by companies in the global market. Both the dynamics of the market and the risk involved shape the type of government policy that is able to enhance fertilizer provision in the domestic markets. However, from the point of view of access for medium and small producers, unexpected fertilizer price increases might call for government action. This action would be better addressed to technology dissemination including the proper use of fertilizers to promote environmentally friendly cropping.

- **Infrastructure⁴⁰, energy and logistics**

Infrastructure is a critical chapter of agro-industrial development. In general, investment in infrastructure is known to contribute significantly to an economy's growth and promote its international trade. In contrast, a deficient infrastructure hinders growth and creates obstacles to fight poverty, particularly in the areas of health care and quality of life, and limits the opportunities to undertake productive activities.

In the Latin American case, Fay and Morrison (2007) signal that since the past decade the majority of LA countries have not devoted enough resources to infrastructure. In effect, public investment has fallen in terms of GDP owing particularly to adverse economic cycles. Additionally, efforts have been highly uneven, relatively abandoning investment in basic infrastructure (roads, railways, electricity, ports and waterways) in favor of the social infrastructure (the distribution of domiciliary services). MERCOSUR countries have not escaped this regional trend.

As a result, the infrastructure in almost every MERCOSUR member country is inadequate and its quality is well below standard. The consequences in terms of economic growth are evident: recent estimates indicate that a comparable infrastructure level with that of the Republic of Korea would add an annual growth rate for MERCOSUR countries of between 2.6 and 4.4 per cent of GDP (Calderón and Servén, 2004).

In turn, the poor quality of infrastructure implies notable increases in logistics costs. These costs represent approximately 10 per cent of the value of the products of industrialized countries; in Latin America, these costs oscillate between 15 per cent (in the case of Chile) and 34 per cent (in the case of Peru).

The private sector, on the other hand, has not satisfactorily met investment needs in infrastructure. By nature, this kind of investment presents key "externalities" and characteristics of "public goods" that make them less suitable for private investment. This is particularly relevant concerning investment in roads, some kinds of transport, electricity and ports, in

⁴⁰ According to the World Bank estimates, developing countries currently invest 3-4% of their GDP in infrastructure annually; yet they would need to invest an estimated 7-9% to achieve broader economic growth. UNCTAD(2008).

different degrees. In some cases, the regulatory framework of the services has made their organization possible through “quasi-market” modalities.

During the 1990s, South American governments, and MERCOSUR governments in particular, strongly reduced public investment in infrastructure. Causes for this cut in public spending can be linked both to the financial situation and to the change in paradigm that placed the management of public services in the hands of the private sector.

Public investment in infrastructure fell from an average of 3.1 per cent of GDP in the period 1980-85 to 0.8 per cent in the period 1996-2001 in the six largest countries in the region as a whole,⁴¹ while private investment rose from 0.6 per cent to merely 1.4 per cent. Public investment was slashed, particularly in Brazil, from over 3.6 per cent of GDP in the 1980s to almost 0.6 per cent in the second half of the 1990s.

Infrastructure is also important for the competitiveness of companies and international trade. In the case of Latin America, for example, deficient infrastructure is one of the greatest sources of concern for private companies, as can be seen in the World Bank’s Investment Climate Survey: 55 per cent of companies consider that inadequate infrastructure is an obstacle to investment.⁴² Based on this survey, Escribano et al. (2005) estimate that over half of the firms’ productivity can be explained by variables related to infrastructure.

Infrastructure also impacts decisively on logistics costs. Transport is a key component in moving merchandise. Deficiencies imply greater stockpiling and, hence, the elevated financial costs of inventories.⁴³ This raises the costs for companies and reduces the economy’s competitiveness.

The LA region, and, in particular, MERCOSUR has not performed better than other countries with a lower average income. In this section we follow the Fay and Yepes approach (2003) to calculate the value of the stock of infrastructure across countries. The types of capital to be included in the estimate are transportation (paved roads and rails), telecom (main lines and cellular phones), electric capacity generation, and water and sewerage networks. Basically, the methodology considers the different types of infrastructure in physical units (e.g. GWH, kilometers of paved roads, telephone lines, etc.) and converts them into constant American dollars using international “best practice” unit costs. In this way, it is possible to add different types of capital into one unique measure (amount of money). The main advantage of expressing the infrastructure stocks in value - in constant US\$- is the possibility to compare them across countries easier.

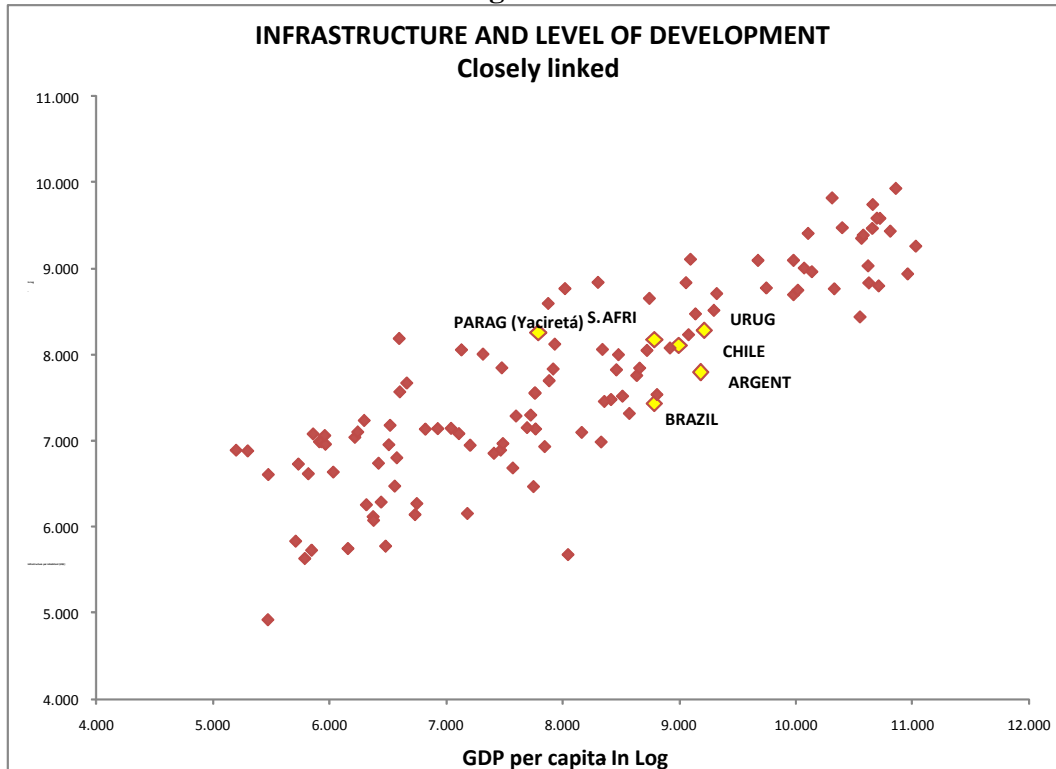
Figure 11 shows the strong relationship between level of development measured by the GDP per capita and the stock of infrastructure also per inhabitant. Among the analyzed countries, Paraguay is the one with the lowest income per capita but shows a relatively high level of infrastructure explained by the huge investment in a hydroelectric power station (Yacyretá). Brazil and Argentina are the members with the scarcest infrastructure.

⁴¹ Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru and Venezuela.

⁴² This percentage is only matched by the countries comprising the Middle East and Northern Africa.

⁴³ Guasch (2002) estimates that the inventories equal 15 per cent of the US GDP, while the average for developing countries is far more than twice that number.

Figure 11



The following table shows some basic physical indicators for our selected countries. The MERCOSUR members have higher electricity generation capacity per capita than the average of Latin American countries and similar to the world average. However, the MERCOSUR figure is influenced by the electrical capacity of Paraguay given that the three other countries are below the world average and below both, Chile and South Africa.

Regarding telecommunications, if main lines are taken as measure, member's countries display a better coverage than the rest of the region and also than South Africa but slightly lower than the world. However, the number of cell phones allowed all the countries to reach the world average, what is particularly important for Brazil and Paraguay, behind the rest in main lines. The technological change in telecoms reduced the costs of access and contributed to the diffusion of these new devices for communications.

Brazil and Paraguay stay behind the compared countries regarding the extension of roads. Even though this comparison does not take into account differences in geography and the productive structure (e.g. commodities production demands a different system of conveyance than service supplies) among other factors, interviews have confirmed the lack of adequate land transportation infrastructure in both countries.

Table 10

INFRASTRUCTURE INDICATORS

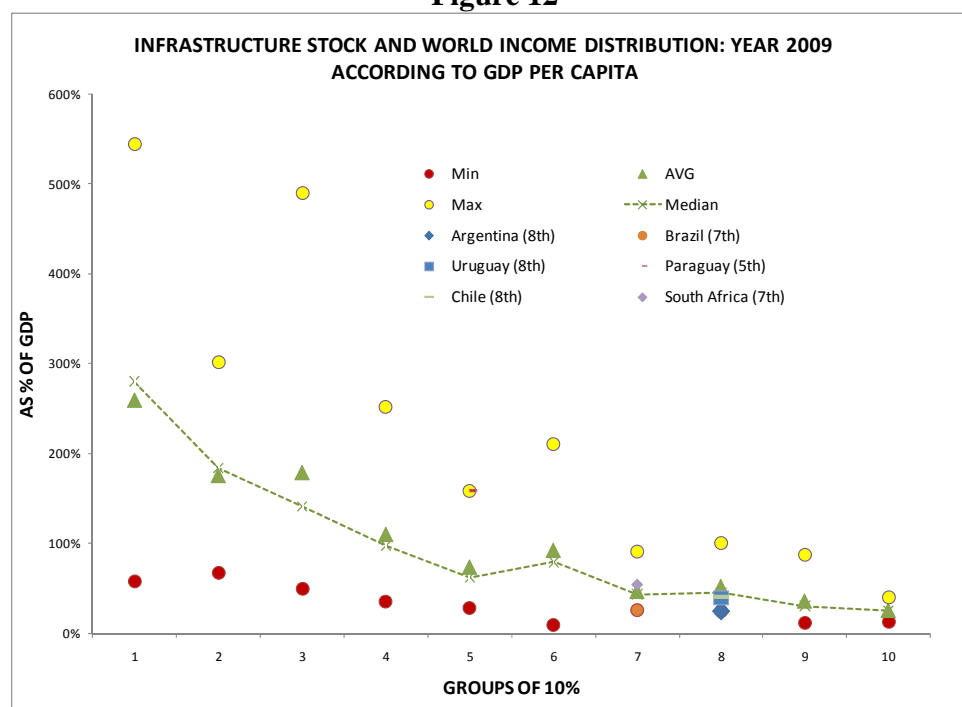
Year 2005

Country	Power Generation Capacity (kw per 1000 inhab.)	Main Lines (per 1000 inhabitants)	Cell Phones (per 1000 inhabitants)	Paved roads (km per inhabitants)	Rail road (km per inhabitants)
Argentina	613	229	552	1.7	0.1
Brazil	456	207	361	0.8	0.0
Uruguay	654	381	410	2.8	1.0
Paraguay	1450	71	460	0.6	0.2
MERCOSUR	793	222	446	1.5	0.3
Chile	968	308	585	1.0	0.1
South Africa	1094	181	499	1.9	0.1
Latin America and the Caribbean	503	195	319	1.5	0.3
High income countries	2161	641	1332	11.9	0.4
WORLD	740	235	458	3.8	0.4

SOURCE: Based on the World Development Indicators and own estimates.

When countries are ordered by group of income, the low stock of infrastructure in Brazil and Argentina is noticeable. The former is included in the 7th decile of income among world countries and shows the lowest stock to GDP (26%) whereas the group median is of 43.6%. Also Argentina, belonging to the 8th decile of the income distribution, presents a ratio of 25%, the minimum of this group. Notice also that, in general, the relationship of the stock/GDP ratio is decreasing with the per capita income.

Figure 12



Taking the two most important component of infrastructure for the production of goods, roads and electrical capacity, the international comparison suggests that:

- a) Paraguay is well above its comparisons in electric supply. In fact, the country is included in the 5th decile according to its GDP per capita and has the highest electrical capacity in the group (equivalent to 126% of its GDP).
- b) To lesser extent, South Africa and Chile have a capacity closer to their maximums in their income group, with 35% and 29% of their product, respectively.
- c) Using these estimations, Brazil's electrical capacity is equivalent to 15% of its GDP and is slightly below the median (19% for the income decile). Argentina (13%) and Uruguay (13%) have lower ratios than the group figure (21%).
- d) Among the six countries, only South Africa ratio of roads to GDP is close to the group median (equivalent to 13%). Uruguay is below by 2 percentage points (13% and the median of 15%).
- e) On the other hand, Brazil, Chile and Argentina have ratios well below the medians of their income groups.

In the case of MERCOSUR as a region, the infrastructure (that is, roads, electricity networks, etc.) has not been built to fit a specific integration, but mainly to serve the domestic market. Hence, as mentioned in IDB (2000), MERCOSUR roads, which concentrate international cargo traffic, show a much smaller participation of this type of traffic than the domestic traffic that circulates along these roads.

Road transport is the principal problem in the main MERCOSUR corridors owing to bottlenecks for the lack of capacity, as is reflected in the number of accidents. For example, Route 14 between Argentina and southern Brazil is called the "death route" for the many accidents that are reported there.

Sánchez and Cipoletta (2003) indicate that the lack of coordination between organizations and public officials within the same country and between countries, and corruption at the bureaucratic level hamper more fluid road transport and delay the integration process. The authors estimate that the impact of inefficiency costs and its financial burden amount to between US\$ 32 million and US\$ 54 million annually for the border passing between Argentina, Brazil and Uruguay. In the case of the border passing between Argentina and Brazil, this loss is equivalent to US\$ 170 per truck, which reflects a high relationship regarding the cost of shipping between the two countries. For this reason, the authors conclude that the problems have less to do with capacity than with organization and bureaucracy.

The railroad system, instead, has very little participation in international transport since they were originally built for internal transport, and maintenance in recent decades has been quite inadequate. Railroad density (total railroad length by country area) is 11,3 Km per thousand sq kms of territory; in Uruguay this figure is 9,3; in Brazil a very modest 3,4 and in Paraguay, where railroads are practically no used, it is 0,09 (see Table in Statistical Annex) Nowadays, the poor condition of some stretches of the network generates delays in transport; the differences in the

width of rail gauges persist; and multimodal links do not suffice. For this reason, rather than having a regulatory nature, the problems are mainly a matter of infrastructure.

Waterways show key potential for transport but little has been done to take advantage of this source. The main MERCOSUR basins, that is, the Amazons and the Paraguay-Paraná River basically target extra-regional trade or traffic between ports in the same country. The principal limitations can be attributed to inadequate intermodal connections.

Ports have improved their productivity over the past decade. Yet, problems exist in the terminals that have to do with access or the lack of multimodal connections.

In the case of Paraguay, the importance of transportation and communication infrastructure is relatively more relevant due to its condition of “landlocked” developing country, depending of a narrow range of export commodities. It has been estimated that the fact that Paraguay does not have a coastline implies an additional cost of between US\$30-40 per MT for export of soybeans. Restrictions in regulation along with poor availability of infrastructure cause very high transport costs. Under Paraguayan law, all maritime and river transport of imports and exports is reserved for Paraguayan-registered vessels. This restriction has been eliminated for river transport in vessels registered in the countries party to the Hidrovía (Paraguay-Paraná River Waterway) Treaty. Cabotage river transport is reserved for Paraguayan-registered vessels. The private sector may build and manage river ports in order to provide commercial services, but airports providing similar services must be managed by a government agency.

In the Brazilian case, transport infrastructure is recognized as a major bottleneck by both private companies in the agro-industrial chain and the government itself.

For instance, 60% of the crop volume is transported by highways, 80% of which are rated as deficient or in bad conditions.⁴⁴ Railway transportation accounts for 21% of the volume. Trains run at an average speed of only 25 km/hour.⁴⁵ A recent document by the Secretariat of Strategic Affairs (SAE) asserts that one of the restrictions to growth of Brazilian agribusiness is the imbalance between production capacity and logistics infrastructure. SAE initiative proposes a new model of transport integration, coordinating highways, railways, waterways and pipelines. In the case of highways and railways, they propose to combine competition and regulation to reduce the cost of the latter relative to highways. This will need the granting of new concessions for rail transportation. As it will be explained below, this kind of contract is adequate for the attraction of new (foreign) investors to the sector. According to the document waterways have to be expanding for improving navigation capacity of the rivers.

In Brazil and Argentina, international companies related to grain logistics have been present since the inception of the exporting activity. Bunge, for instance, runs Fertimport that started operations in 1947. At present the company provides a full range of services such as chartering services; port operations, customs clearance, importation and exportation process management and sales agency for sulphur and fertilizers.

⁴⁴ Unit transportation cost of soybean in Brazil is 2.5 times that of the US.

⁴⁵ In USA the speed is around 80 km/hour.

The role of the State in the design, planning, contracting and financing of basic infrastructure is well-known. Unfortunately, developing countries fail to deliver efficient infrastructure services, particularly for business, due to the lack of long term planning and financial instruments. Brazil has tried to overcome this problem by launching in January 2007 a comprehensive program the “PAC” (Growth Acceleration Plan) that prioritizes long term projects, with a horizon of 15 to 20 years. This ambitious project was complex in terms of organizing tenders, environmental licenses and political coordination agendas. Some analysts have criticized that the lack of a transparent regulatory framework does not favor private investments in the projects, both from the public private partnerships and the concessions. However, from the very beginning the completion of the financing required the participation of private investors. According to the plan, 13,5% of the total funding would come from the federal budget and 86,5% from state companies and the private sector. In the logistics area, the government has selected 72 priority projects. The Southeast region will be the main beneficiary of the investments, with the Northeast and Midwest in second place, followed by the Northern and the Southern regions. Critics have pointed out that in terms of the priorities established for the development policy package the transportation investment issue came in after the social and urban sector and energy. On the other hand, proponents of the plan emphasize the inclusion of most of the initiatives to reduce the main transportation bottlenecks (federal highways, railways, ports, airports and waterways)⁴⁶

Infrastructure is by itself a major determinant of the competitiveness of an economy and for that reason, one important factor taken into consideration by international investors in their decisions. In opinion of the businessmen interviewed for this study, the increase in freight prices caused by higher demand requires to streamline logistics to meet global market demands effectively. Unfortunately, MERCOSUR countries along with most of LAC exhibit a rather unbalanced development of business infrastructure as compared with social infrastructure and between rural vs. urban infrastructure. This fact in general hinders competitiveness and delays growth in highly competitive sectors as agro-industry.

At the same time, infrastructure investment is recognized to be relatively capital-intensive, complex and often involving networks. A key question is as to which extent FDI can contribute to release developing economies from infrastructure bottlenecks. The monopolistic nature of some of these investments and the social and political issues regarding access to infrastructure services introduce additional complexities to the role of FDI in this sector. However, during the 90s various initiatives paved the way towards modernization of infrastructure provision in developing countries, particularly in Latin America. Private participation in infrastructure (PPI) has been important. Concessions have been used mostly but privatizations have attracted more funds due to the size of the utilities involved. Concessions offer the investor the right to develop a service. Bids for new projects were often tendered under the modality of build, own, and operate (BOO), particularly in power plants and gas pipelines. Privatizations constituted a transfer of property to the investor.

⁴⁶ Investment in infrastructure connected to the organization of the 2014 World Cup and the 2016 Olympic games have concentrated a lot of attention of international and domestic investors. Public banks are also involved in the financing of these activities. These engagements could affect the development of non-urban projects in the short run, as reported by the Brazilian Infrastructure Panel of the Latin American Equity Research-Santander.

Between 1990 and 2003, Argentina and Brazil, as leading members of the MERCOSUR, together with Chile, Colombia, Mexico and Peru, received the greatest share (93%) of the PPI flows. The telecommunications sector attracted 46 per cent, electricity 32 per cent, transport 17 per cent, and the supply of water and sanitation 5 per cent.

Since 1998 PPI has fallen sharply given that the major privatization programs have ended and also because investors have lost interest. Success was not evenly distributed among the new models of privatized, regulated and/or public-private provision of infrastructure services. One striking aspect of infrastructure concessions was the recurrent renegotiation of contracts. In Latin America between 1985 and 2000, 30 per cent of over 1,000 concessionaires renegotiated their contracts. A noteworthy case is the distribution of water where the renegotiation reached record levels.⁴⁷ Government has not always been the ones to initiate the renegotiation process as the private sector also has strong incentives to try to modify contracts, especially when the concessionaires have overestimated their projections for demand or when the tariffs they offer do not cover costs. An opportunistic behavior exists on the two sides, that is, the licensing authority and the concessionaire. In some serious cases, concessions have been revoked or contracts breached.⁴⁸ However benefits were high in many chapters where private participation has consolidated its role (telecoms, energy). TNCs have participated as direct investors but also and most important, as investors in schemes of private-public partnership and private participation in infrastructure projects involving concession contracts. Concessions are particularly predominant in the case of FDI in transport infrastructure.

In MERCOSUR the energy supply matrix is very different between countries. Paraguay and Brazil are outstanding energy producers from hydroelectric (environmentally clean) sources (See Table below). At the same time, Brazil is one of the world leaders in biofuel consumption for the automotive market.

Paraguay is one of the major producers of electricity per capita in the world and a large exporter of electricity. Nevertheless, in 2003, consumption of electricity accounted for barely 11 per cent of domestic energy consumption. Distribution problems limited the development of local companies exploiting this advantage. Some of them have built up their own facilities to achieve connection to the Hydroelectric sources. In Paraguay the energy sector is dominated by two State-owned companies, *Petróleos Paraguayos* (PETROPAR) and the *Administración Nacional de Electricidad* (ANDE). Although the hydrocarbons subsector has been subject to reforms aimed at increasing the share of private investment, the electricity subsector remains a public service operated by the ANDE.

⁴⁷ According to Guasch (2004) 74 per cent of the water and sanitation concessions in Latin America have been subject to renegotiation.

⁴⁸ In 2007, the World Economic Forum elaborated a report aimed at identifying the main drivers of private investment in infrastructure projects in a selected number of Latin American countries, and at mapping out country-specific weaknesses and strengths in this regard. In their appraisal Brazil turns out to be the most attractive country after Chile at the same time that the Brazilian infrastructure exhibits one of the highest gaps in the region. Low political risk and a remarkable track record of private investment in infrastructure with few projects cancelled or distressed explain its performance. Uruguay presents a good perspective as well. On the contrary, Argentina shows one of the highest percentages of projects distressed or cancelled (44% over 1990-2005).

Table 15

Installed Capacity in Electricity Generation By type of plant (as a share of total)					
	Argentina	Brazil	Paraguay	Uruguay	AL&C
Hydro	35,0	75,7	99,9	69,0	52,6
Thermo	61,3	22,0	0,1	31,0	44,9
Nuclear	3,6	2,1	-	-	1,6
Others	0,1	0,2	-	-	0,9
Total MW	28.184,9	95.191,9	8.116,1	2.228,0	267.137,6
KW per capita	0,74	0,53	1,44	0,68	0,47

Massive ethanol production in Brazil opens the possibility of energy production based on this source, especially when considering the environmental balance of each energy source, as may be the case in the near future.

The integration of infrastructure with respect to electricity has been more specific. Networks have been laid out between the different countries (that is, Argentina – Brazil, Brazil – Paraguay). The same applies to the gas pipelines, where the development of the transport network has been striking, involving Brazil and Bolivia; Argentina and Chile; and Brazil, Bolivia, and Uruguay. As in electricity networks, most investments in gas have been led by private initiatives with the participation of public companies and under public regulation. However, a major step is that the connections and networks move away from being a market of supply contracts to being a veritable regional energy market through the harmonization of operative and regulatory instruments.

- **Return on investment and cost of capital**

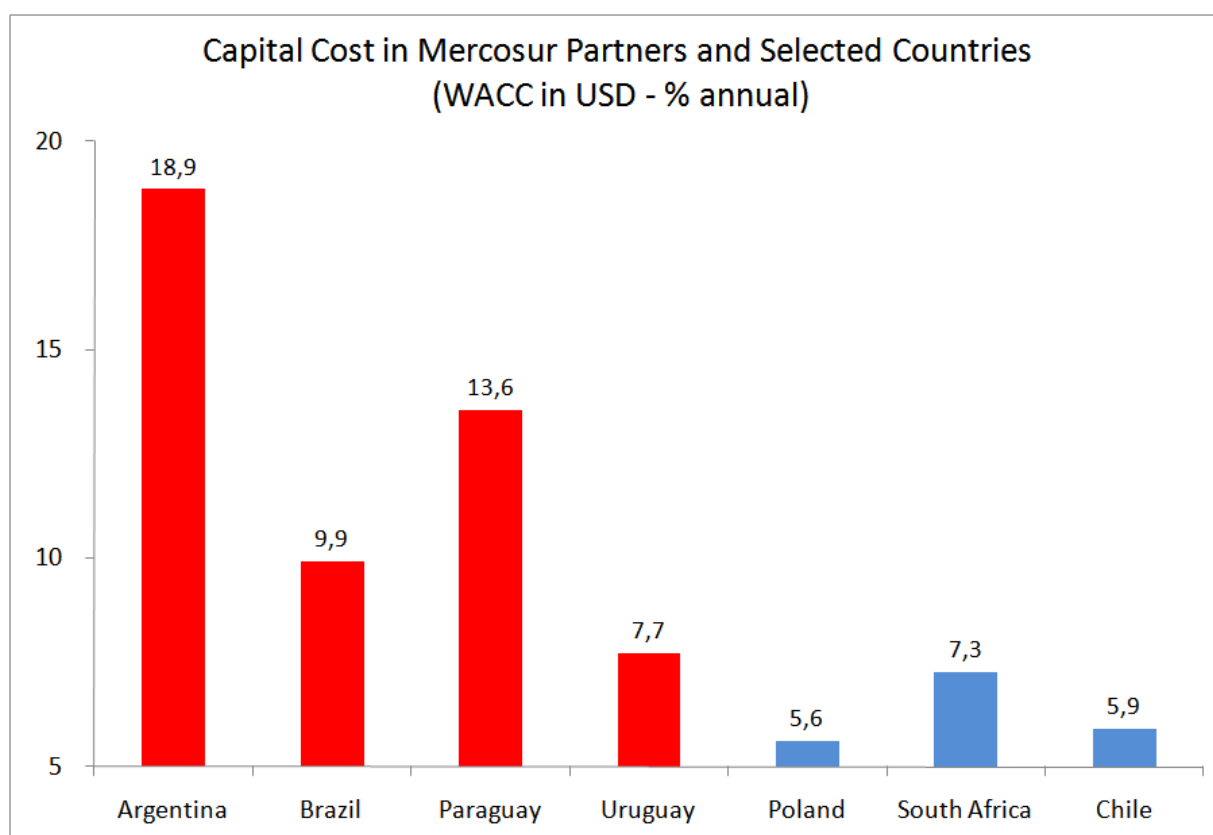
Broadly speaking, a company's assets are financed by either debt or equity. The cost of financing is generally estimated as the average of the costs of the combined sources of funds, each of which is weighted by its respective share in the financing portfolio (WACC- Weighted Average Cost of Capital). By taking a weighted average, it can be seen how much interest the company has to pay for every dollar it finances. A firm's WACC is the overall required return on the firm as a whole and, as such, it is often used internally by company directors to determine the economic feasibility of expansionary opportunities and mergers.

The WACC is an appropriate discount rate to use for cash flows with risk that is similar to that of the overall firm. In the case of FDI, risk perception may be higher due to imperfect information concerning market conditions, national rules and regulations. Managers are aware that investment opens new opportunities that may be undertaken or postponed into the future. Thus, they behave as if they owned option-rights thereby computing the optimal investment (exercise) timing.

The following chart shows the Weighted Average Cost of Capital for MERCOSUR countries in 2009. Three other economies, competing for FDI with MERCOSUR have also been included as a benchmark.

These figures are worth comparing with the rates of returns reported by the CEOs and bankers interviewed for this study (see section 3). In general, the upper end of the range of the reported rates of return tends to be slightly higher than the cost of capital, probably due to differentials in risk perception by foreign investors and/or to specific sector characteristics. Notice that all of them are above the cost of capital in benchmark countries, with the Argentine figure reflecting the influence of a very high country risk index.

Figure 13



Source: Own based on market data.

2.3. Business Opportunities

MERCOSUR is recognized for its unique comparative advantage in agricultural production. Manufacturing processing of agro-industrial inputs is also a well-established activity in the region, particularly in the case of Argentina and Brazil. The interviews held for this study have shed light on the kind of obstacles to investment and limitations in the business environment that affect the development of business opportunities in MERCOSUR countries. At the same time, the private sector, especially in Brazil, Paraguay and Uruguay is very active in pursuing new opportunities in spite of the obstacles. From the economic point of view the presence of obstacles

operate as an extra-tax on private activity, reducing the amount of total investment and limiting growth. In Argentina, where investors fear opportunistic behavior stemming from public decisions (i.e. confiscation or breach of public-private contracts) private sector perspectives are less optimistic and their initiatives more cautious.

During the interviews, entrepreneurs and experts listed various sectors and activities presenting very good prospects. Moreover, the current situation in the international food market is very dynamic and they admitted that business opportunities are opening constantly. However there are a bunch of sectors presenting excellent prospects where they consider that MERCOSUR development is still below its potential and, accordingly, rapid expansion is highly probable. These sectors mentioned more frequently were agricultural production (grains and cattle) through land frontier expansion; dairy products; biofuels; logistics for the agricultural and food sector and forestry and timber processing.

The assessment of opportunities in these sectors is not within the scope of this study. However there are several specific aspects connecting these sectors to FDI modalities that are worthwhile commenting. As a first step some useful inferences about the relative performance of agro-industrial companies in MERCOSUR can be made using standard market information.

Two indicators will be considered regarding the valuation and risk of food and farming companies in each country: the price to earnings ratio and a measure of non-diversifiable risk- the Beta - used in finance. The data used for the estimation include more than 30,000 companies around the world at the end of 2009⁴⁹. Estimates elaborated correspond to the selected sector and the total stock market for each country.

The company's stock price to yearly earnings (P/E) is a measure of expectation of future profits. The higher the P/E ratio the better is the expected net income in the future, thus justifying a high valuation of the company. This valuation depends on several factors, among them, the expected performance of the company' sector, the capital structure (higher financial leverage increases the financial risk and the required return), the management of the company, the business environment, etc. Notice, for instance, that whenever a given sector faces a differential expropriation risk or tax burden, companies in that industry will exhibit a lower price-earnings ratio.

The relevant measure of risk is the one that can't be diversify in a wide portfolio of financial assets. In fact, according to the Capital Asset Pricing Model (CAPM), one of the most popular models in finance, the expected return of a particular stock depends on the general return of the domestic market, the risk free- rate (e.g. the government bond yields) and on the volatility that this company adds to the market portfolio. Thus, the company will have a higher return than others if it is riskier and this risk cannot be diversified by including the stock in a standard portfolio. An asset with a Beta of 0 means that its price is not at all correlated with the market⁵⁰.

⁴⁹ The original dataset contains more than 30,000 firms listed in 113 stock exchanges. However, only 25,000 of the total of companies have the required financial information.

⁵⁰ The Beta will take different values depending among other factors on:

- a) Fixed costs and sales. All else the same, higher sales to fixed costs, the higher the volatility of earnings and the Beta.
- b) The financial leverage, high debt allows to earn more during good times and also to have greater losses during downturns.

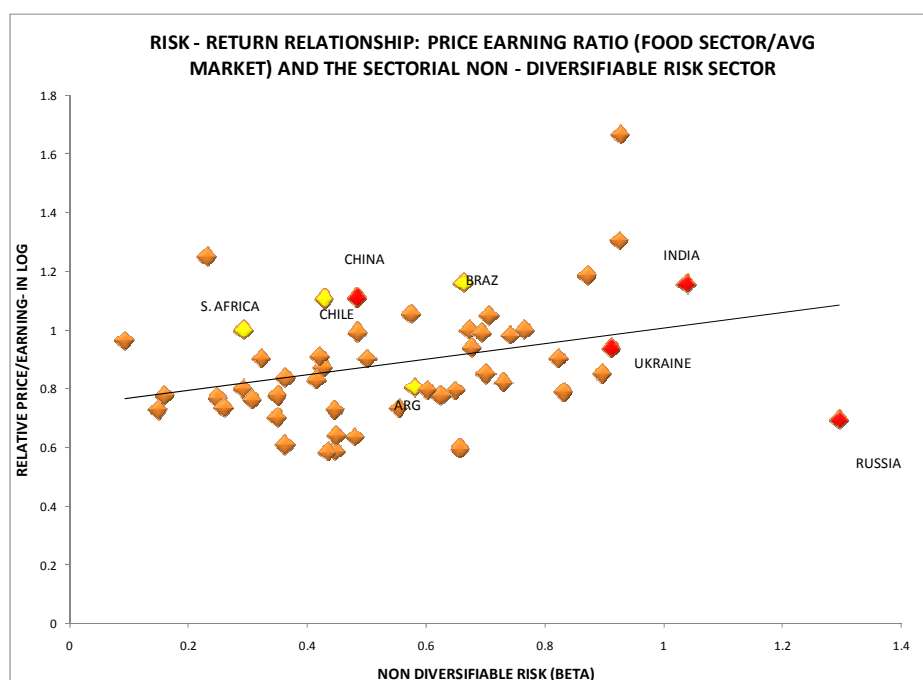
The level of the P/E ratio of the sector may be affected by the evolution of the whole market. In fact, the estimates show that the Chinese food companies (P/E = 220) are at the top of valuations followed by the Brazilian (77) and Indian (59) companies, three of the most flourishing emerging markets in recent times.

For this reason, the sector P/E was adjusted by the general market P/E ratio. That is, most of the high valuations of the sector's firms might be based on the economic and political performance of each particular country rather than on the particular performance of the farming and food processing companies. By adjusting the sector indicator, this influence is eliminated.

The results shows that in countries such as South Africa, Chile and Brazil the relative P/E ratio is above the average of the world controlling by the Betas. Argentina, on the contrary, is below the general average (shown by the trend line).

To sum up, financial indicators suggest that food companies in Brazil (Chile and South Africa as well) have better prospects than the comparative world average company while Argentine food companies are below the world benchmark.

Figure 14



Source: Own based on market data.

- c) More cyclical companies have more volatile profits.
- d) More diversified the company, less volatile its earnings.
- e) Larger the scale, less volatile the net income. Greater companies have a lower beta. This explains why firms in mature markets show low variability of profits.

(See details in Statistical ANNEX)

Considering now some specific aspects behind these prospects and as regards agricultural production, the main drivers of international investment include the availability of land and water in the host country in a scenario of fast growing international demand for food and energy. In the 2000s the expansion of international agricultural markets and the increase of international commodity prices resulted in high returns for this, otherwise, traditional business attracting new investors and promoting new FDI modalities. Government initiatives to establish a statutory use of biofuels for cars also helped to spur agricultural demand and created new opportunities to expand innovative crops as jatropha.

As for MERCOSUR, key agricultural resources are abundant relative to the rest of the world and the regional economy offers very good prospects in the medium run as compared with other potential locations in the developing countries. In the case of Brazil, Camargo Barros et al (2009) have estimated that in the past two decades Brazilian agricultural output grew rapidly and practically only because of yields increases. Only very recently, the land frontier has resumed expansion. They attribute the continuous growth of agricultural output to integration to international markets. These authors consider that if Brazil is able to attain high domestic GDP growth rates, a strong growth of domestic demand for agricultural products is to be expected. In this scenario, if investments in science and technology are maintained and international integration expanded, Brazil will be able to substantially increase its supply of agricultural products both domestically and to foreign markets.

In the case of Argentina, the performance in agricultural productivity has been outstanding. Over the 1980-99 period, TFP in agriculture grew by 2,2% annually, which compares very favorably with 0,95% in USA and 1,29% in Australia. Since late 2003, price hikes in international commodity markets also allowed the “exportation” of the Pampas production system to marginal lands in the NE and NW provinces of the country. Prices grew so fast as to include every marginal area into crop production at the expenses of cattle, sugar and regional products. Soybean development and its related technology change were at the center of this productive revolution. The effect was so important as to displace part of the economic activity and urbanization growth from the Buenos Aires area towards Rosario and Cordoba, up center in the country.

Wheat production deserves some attention. This is a particular case of regional trade where Argentina was the traditional supplier to Brazil until very recently. Due to agricultural policy distortions, the former country lost its exporting capacity and at the same time Brazil has developed an incipient wheat production with good prospects for the future.

Regarding forestry, according to FAO (2002) production of woodbased materials is continually increasing in efficiency. The area of plantations is also growing rapidly: production of industrial roundwood from plantations is expected to double by 2030, from 400 million m³ today, to around 800 million m³. Forestry can help to soak up some of the carbon released by human activities. Brazil and Uruguay have very good prospects in this market. Paraguay used to be a competitive producer and Argentina has a good potential, both countries should revise their policies in this sub-sector.

In dairy production, Argentina and Uruguay are competitive exporters of powder milk, the most important product (in fact, a commodity) in this international market. Brazil is an importer from the region but has a very good potential to develop.

Biofuels are a booming sector in MERCOSUR. On the one hand, Brazil is the largest ethanol based on sugarcane producer in the world. The country is highly competitive in both sugar and ethanol. Public support helped to develop the sector in the past but it is no longer subsidized. On the other hand, Argentina is a competitive producer of biodiesel based on soybean oil. Domestic and international companies are actively working in both countries. Paraguay is perceived as a potential prospect for investments in biofuels by international investors, mainly biodiesel. Notwithstanding, other non-traditional biofuels are being tested. For instance, in 2009, Spanish capitals initiated there the development of a biodiesel plant using “mbocaya” as the main input. Total investment amounted to EU\$ 14 million. The project was supported by agreements with the authorities, particularly with REDIEX.

Each of the previous selected products have been mentioned in the interviews for this study as very good prospects due to expected development of international markets and competitive advantages for local processing.

3. The entrepreneurial point of view: transaction costs and perspectives

Formal barriers to foreign investments are low in MERCOSUR countries. However, obstacles and over-costs due to political or economic risks and failures in the efficient operation of the agro-industry value chain⁵¹ may be perceived differently by different categories of investors. This fact may convey differential rates of returns for new projects to foreign as compared to domestic investors. The degree of uncertainty is affected by environmental and organizational factors such as the nature of the business and of the specific project, as well as the personal characteristics of the decision-maker. As a result, there will be a set of projects that may be considered as rewarding enough to be undertaken by domestic companies but are not attractive for foreign investors. At the same time, domestic companies may be restricted in credit, technology or other managerial capacities to carry on the new business. Thus, a percentage of potential projects will be lost for the expansion for the sector. Some of these projects may be key ones to complete the operation of the value chain.

According to this idea, besides formal barriers and standard risks appraisal which have been reported in the previous sections, the complete diagnosis of the situation also requires an assessment on the relevance of each obstacle in the field. For this purpose a series of interviews were conducted in Argentina, Brazil and Paraguay to international and local investors and companies, experts and public officials connected to agro-industrial development.

Under the umbrella of the FDI statistics, a number of different business actors are in operation. Transnational companies are the most representative, but more recently private investment funds and Sovereign investment funds have increased their participation. Even in the case of

⁵¹ These over-costs are usually referred as “custo Brasil” or “costo Argentina”

transnational companies, a distinction can be introduced between private and publicly owned firms. In fact, the profile of each investor is crucial considering observed differences in risk tolerance by type of investor.

Private investment funds are important newcomers to agricultural investment. Particularly, during the increase in commodity prices that took place since late 2003 they started buying land at low prices in developing countries, particularly in MERCOSUR, combining real estate investment with agricultural production activity. Valorization of the real estate held the most important share of the business profitability at the beginning. Examples of this kind of investors are Cresud SA; Pampa Holding and BrasilAgro, among others. Local investors were also heavily involved in land business. At the same time, grain production, cattle raising and dairy production benefitted from increased capital and new technology adoption in these projects.

A different model of FDI involved the use of investment funds to rent large quantities of land to devote to commodity cropping. Large scales allowed for important cost-reducing effects and risk pooling of products and also improve trading conditions in the markets. This business model was widely spread in Argentina and extended to the rest of the region attracting local and foreign investors as well (Los Grobo, El Tejar, Espirito Santo)⁵²

Other important foreign actors in MERCOSUR are TNCs operating in the agro-industry value chain as input and service providers. International commodity traders, agrochemical producers and logistic service providers participate of this market. Considering that business opportunities in the region are practically unique in the world (farmland expansion combined with highly organized domestic markets), these companies are permanently seeking new projects. International banks are also interested in expanding activities in MERCOSUR.

Historically domestic companies have shared the market with foreign companies and some of them, particularly in Brazil have developed themselves as global companies since mid 90s.

Taking into account this diversity, the list of interviewees for this study included CEOs of a group of international and domestic companies at different stages of the agro-industrial value chain and a group of bankers and experts working with the sector (See list in References). Interviews were conducted under a common questionnaire (See Annex: Questionnaire) and each interviewee was free to add their opinions. The results were used to guide the selection of subjects and give priority to them in the analysis. In addition to the opinions already reported in previous sections, the following Tables show complementary information of the interviews useful to our diagnosis.

⁵² Los Grobo, MSU and El Tejar are investing in agricultural production in MERCOSUR countries, particularly Los Grobo administers a business of 250.000hectares rented in the region, 35% corresponding to Brazil.

Table 18

Investment determinants according to their importance*	Main determinants	Others
High	activity of competitors in the potential market, market size,	natural resource availability: MERCOSUR is an unique opportunity for land and water Medium companies under non-professional management are very attractive to private investment funds.
Medium	skilled labor availability, low cost agricultural inputs	Brazil and Paraguay: there are many business opportunities in new locations (MAPITO in Brazil and Alto Paraguay)
Low	availability of domestic financing**	

Notes: * Foreign companies, bankers and experts opinions, except when stated otherwise. ** International companies have declared to be interested in a fluid domestic credit market.

Table 19

Investment obstacles according to their importance	Main obstacles	Others
High	In Argentina: lack of compliance with the rule of law, confiscatory risk, barriers to export and barriers to capital mobility In Brazil: excessive tax burden In Paraguay: energy production is abundant but its distribution is highly deficient	Insufficient supply of strategic inputs and infrastructure (Brazil: fertilizers and railways. Argentina: railways. Paraguay: roads, railways, waterways)
Medium	In Argentina: macroeconomic instability and excessive tax burden In Argentina and Brazil: judicial effectiveness particularly in labor conflicts (Argentina) and in contract compliance (Brazil, Argentina, Paraguay) Barriers to import	In Brazil and Paraguay: land titles. Argentina and Brazil: contingent liabilities difficult to evaluate in acquisitions of highly indebted and often informal medium companies. Brazil and Paraguay: stringent environmental regulations Brazil, Argentina: insufficient energy provision
Low	Barriers to invest in specific sectors and regions	

Table 20

Public Policies affecting investments according to their importance	Main policies	Others
High	Stability of economic policy (exchange rate) and international agreements guaranteeing foreign investment protection and national treatment. Bilateral double taxation treaties Public investment and financing of infrastructure	In Argentina: lack of an important capital market
Medium	Fiscal promotion and local government fiscal benefits to invest (Brazil)	In Argentina: instability of tax rules at the local level (provincial gov.)
Low	Bilateral trade agreements between MERCOSUR and the rest of the world. Harmonization of rules regulating trade, taxes and investment in MERCOSUR.	

In Argentina, many respondents believe that the adverse business environment has influenced the observed lack of relevant investment projects in the agro-industrial and infrastructure sector. This fact contrasts with the optimistic perspectives about the agro-industrial sector in MERCOSUR that they also declare to foresee. Bankers pointed out that demand for loans by agrifood companies is concentrated in short term working capital.

This situation is contrasting with the case of Brazil where companies are interested in long term loans to develop new investments. In their role of credit suppliers, private banks compete to provide loans for investment and companies are able to combine different sources such as private investment banks, commercial banks and public banks (BNDES is the source of long term lending). Moreover, in Brazil a great deal of companies of the agro-industrial sector decided to “go public” as a source of business expansion.

Bankers declare not to give preference to projects depending on fiscal promotion schemes, particularly in Argentina. Private funds invest in business over a 3 to 5 year range, but they also pay attention to the prospects of their potential investments in the long run.

Regarding MERCOSUR as a whole, various interviewees considered that lack of compliance with established rules at the regional level created uncertainty to consider the region as a single market. Some also pointed out the asymmetry between Brazilian investors assisted by BNDES and the investors in the rest of the region, lacking this possibility of access to long term loans.

Food processing, particularly dairy products, and agro-industrial logistics are viewed as two highly profitable sectors for expanding investments in MERCOSUR. Infrastructure for the

agricultural sector (railways, storage, waterways, energy) is a kind of business where the private sector is reluctant to enter but for the case of very well-defined projects.⁵³

Finally, interviewees were questioned about the rate of return demanded for projects in the agro-industrial value chain in each country. The results were the following:

Table 21
Rate of return reported for
agro-industrial investment projects - by country

Argentina	18-25% ***
Brazil	12-16%
Paraguay	15-18%
Uruguay	sd

*** Strategic projects in low risk sectors admit lower rates, around 14-15%

4. Policy recommendations and concluding remarks

In MERCOSUR countries, the agro-industrial value chain presents different levels of development and complexity. This study has focused in the potential role of Foreign Direct Investment (FDI) to improve this development directly and indirectly; directly, through expansion of agricultural production and processing; indirectly, through investments to release the sector of the bottlenecks in backward and forward linkages currently affecting the overall agro-industrial competitiveness (infrastructure, fertilizers, etc). Major constraints were identified in land transportation for all four countries while diverse bottlenecks in selected inputs were present in each of the countries (fertilizers in Brazil; energy distribution in Paraguay; railway and fluvial transportation in Argentina, Brazil and Paraguay, management innovation and labor availability in Uruguay, etc). Poor access to financing capital is also a constraint common to all MERCOSUR member countries.

FDI constitutes an attractive financial vehicle for investment. However, it demands deeper involvement of the investor to manage the project and it clearly evidences a closer relationship between the foreign company and the local scenario. There is also more risk owing to lower liquidity in this kind of transaction. This fact explains why it is also more difficult to attract FDI compared with other types of financing, requiring, for instance, full compliance with property rights and exchange market regulations.

FDI also plays a complementary role with domestic capital. In the Brazilian case, for instance, several agri-clusters at the regional level have been identified where international companies such

⁵³ This was the case of Vale do Rio Doce that developed a railway to transport minerals to the maritime ports and fertilizers back to their region.

as Cargill, Bunge and ADM provide services to Brazilian large companies such as Perdigao that has by itself become a global player.⁵⁴

Government inefficiencies and policy distortions are widespread in the region. Various bottlenecks in infrastructure and public services negatively affecting competitiveness are due to government delays and mismanagement of investment plans in this area. Recently, social infrastructure has been given priority against business one.

FDI can be a useful instrument to promote development in the agro-industrial sector, but only in the presence of a threshold of human capital and infrastructure facilities that enable the spillover of new technologies. Thus, host Governments have to play a complementary role in providing the conditions for advantageous establishment of new foreign companies.

Bottlenecks and obstacles to invest affect domestic and foreign investment alike, hurting potential growth in each country. But, foreign investors are more prompted to exercise their options postponing investment, considering their higher uncertainty and the “hold-up” potential capacity of nationals along the value chain.

Finally, many of the weaknesses to attract investors are common to all economic sectors. Some are even more restrictive for agribusiness development, such as transport infrastructure, contract and tax stability, access to land and respect for property rights especially in real state, etc.

In particular, this study has shown the considerable weakness of authorities in MERCOSUR countries to target and implement planned investments in infrastructure. As for the private sector participation in this activity, opinions are divided. While some analysts see legal impediments to extensive private participation, potential investors doubt on their financial capacity and project profitability to engage into long term investments in infrastructure⁵⁵

The four countries analyzed in this document present different situations in terms of their policies to promote the development of the agro-industrial value chain. On the one hand, Brazil and Uruguay have achieved remarkable results in their agricultural production and exports in the short run and are on their way to build a strong position to develop policies for the long run.

In the case of Brazil, several initiatives are operating in the sector; though convergence of efforts may take some time and further organization would benefit the overall results. The elimination or minimization of bottlenecks to agricultural development is an explicit objective⁵⁶ including the need for organizing grain transportation, achieving fluent supply of fertilizers, recovering degraded areas, strengthening the agrofuels market and improving product standards certification. A similar progress is observed in Uruguay. Paraguay is several steps behind as regards the organization and enacting of modern policies, but both the private and public sectors are aware of this need. Instead, Argentina presents a rather conflicting scenario regarding the role of agro-

⁵⁴ This is the case of Goias poultry and pork production described by Rezende Lopez (2002)

⁵⁵ In several of the interviews held, investors already providing infrastructure services in Brazil and Argentina, have expressed this doubt particularly in the case of railways and waterways. Instead, ports and highway concessions are considered more favorably.

⁵⁶ Document “Brazilian Agriculture in the XXI Century”, National Agriculture Plan, Ministry of Agriculture, Livestock and Food Supply and the Secretariat of Strategic Affairs, 2009

industrial development policies and this lack of consensus is delaying the launching of a new agro-industrial growth cycle.

Progress in trade liberalization lessened the importance of traditional barriers (tariffs and quotas) for new investment and competitiveness and heightened that of other barriers or transaction costs, among which are: port efficiency; customs procedures; foreign trade regulations (such as permits of State organizations); and infrastructure services. In consequence, *infrastructure development, competition policy, trade policy and trade facilitation, and R&D are important chapters where the governments of the region need to agree a common strategy.*

International agreements containing investment promotion provisions could help, such as in the case of free trade agreements including investment procedures and expansion between the contracting parties. *Infrastructure investment should be viewed, for instance, as a potentially important chapter in the MERCOSUR-EU relationship.* In fact, it could provide a different approach to overcoming the long standstill in the negotiations between the two blocs by “moving away from a strategy that has so far been almost exclusively based on formal trade agreements to a strategy that reflects more accurately the importance of the obstacles that lie, literally, on the ground” (Mesquita Moreira, 2007).

Even though each location will offer a diverse opportunity to investors, policies promoting a business environment conducive to FDI are becoming the usual approach of developing countries competing for FDI attraction. This fact sets an international standard expected by investors and reduces the company cost of evaluating between alternative locations. *MERCOSUR region should operate in coordination to provide this minimum standard.*

Several analysts have suggested that regional integration affects location decisions of TNCs and therefore influences each member country’s provision of investment incentives, which in turn may trigger relocation. As a consequence, there is a peril that subsidy competition increases as integration proceeds. *From the point of view of the countries in the agreement, policy coordination would be a better response than persisting in a “race to the bottom” of the incentives provided to TNCs.*⁵⁷

One component of policy coordination should be tax harmonization. In many cases tax reform should precede tax harmonization, mainly because the costs of distortions within member countries may be greater than the gains from reducing intergovernmental tax competition.

One basic condition of FDI attraction to Mercosur as a region is the consolidation of the single market. Many drawbacks have been witnessed recently regarding the free circulation of merchandise in the region. For instance, the imposition of (non automatic) import licenses has caused additional delays in the border between Argentina and Brazil in a series of Customs

⁵⁷ Albornoz and Corcos (2005) provide a formal analysis of this phenomenon in an imperfect competition framework, where subsidies should theoretically improve allocative efficiency. They show that, even in this optimistic view of subsidization, subsidy competition leads to welfare losses, when compared to several forms of policy coordination. Argentina and Brazil have just initiated negotiations by sectors that include dairy products, agricultural machinery and wines. They will try to reduce conflicts in these sectors and promote joint initiatives.

retaliations that escalated in 2009. This kind of episodes sends clear signals that business location is crucial to reach a given market in the region.⁵⁸

From the point of view of regional integration, full infrastructure harmonization (physical and regulatory) among the member countries would be highly desirable as it would reinforce the impact on trade growth and the efficient allocation of investment. Initiatives like IIRSA (Initiative for the Integration of Regional Infrastructure in South America)⁵⁹, put in place in the early 2000s to overcome the existing poor situation of LAC infrastructure, could be beneficially expanded to cover more projects in MERCOSUR countries. Coordination of initiatives at the regional agreement level to foster private participation could help to improve quality in contracts including the recovery of investment costs, the avoidance of recurrent renegotiations, and limits on political risks.

International experience suggest that FDI spillovers are concentrated to middle-income developing countries, while there is no evidence of such effects for the poorest developing countries. In the case of MERCOSUR, Paraguay exhibits a lower development level and it may be the case that to take advantage of FDI this country need to enhance its local infrastructure facilities. Uruguay, due to the condition of small economy affected by the macroeconomic cycles of its neighbors, may also require special assistance to complete infrastructure investment. *Widening initiatives similar to FOCEM or IIRSA*, could play an important role in this aspect, improving growth directly by increasing efficiency and new investments and indirectly by enabling FDI spillovers.

⁵⁸ One of these episodes affected the Argentine branch of the Canadian company Mc Cain which produces frozen food and forced it to close down its plant temporarily.

⁵⁹ Funded by the Inter-American Development Bank (IADB), the Andean Development Corporation (CAF) and the Financial Fund for the Development of the River Plate (FONPLATA), it is an ambitious policy undertaking based on a portfolio of projects that encourages private participation and innovative financing schemes.

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AACREA (ARG)

ANDA Associação Nacional para Difusão de Adubos (BR)

ARCOR sa. (ARG)

Benegas, Gladys, Ph. D. Universidad Católica (PY)

BNDES (BR)

Bolsa de Comercio de Rosario (ARG)

Bolsa de Cereales de Buenos Aires (ARG)

Cámara Paraguaya de Carne (PY)

Cadena del Trigo (ARG)

CAPECO (Cámara Paraguaya de Exportadores de Cereales) (PY)

Cargill sa (ARG)

CIARA (ARG)

Citibank sa (ARG)

Dreyfus sa (ARG)

Du Pont Argentina s.a. (ARG)

Fecoprod (PY) Association of Agricultural Producers Cooperatives

Itaú Unibanco Holding (BR)

Pampa Mangement.s.a. (ARG) Private Investment Fund

Peroni,Sosa, Tellechea, Burt y Narvaja. (PY) Lawyers

Profértil s.a. (ARG) Fertilizers

REDIEX Minsiterio de Industria y Comercio

Rabobank (BR)

Salemma sa. (PY)- Supermarket chain

Utepi-Unidad Técnica de Estudios para la Industria- SSEI- Ministerio de Industria y Desarrollo (PY)

Vale do Rio Doce (BR)

STATISTICAL ANNEX

Figure A-1

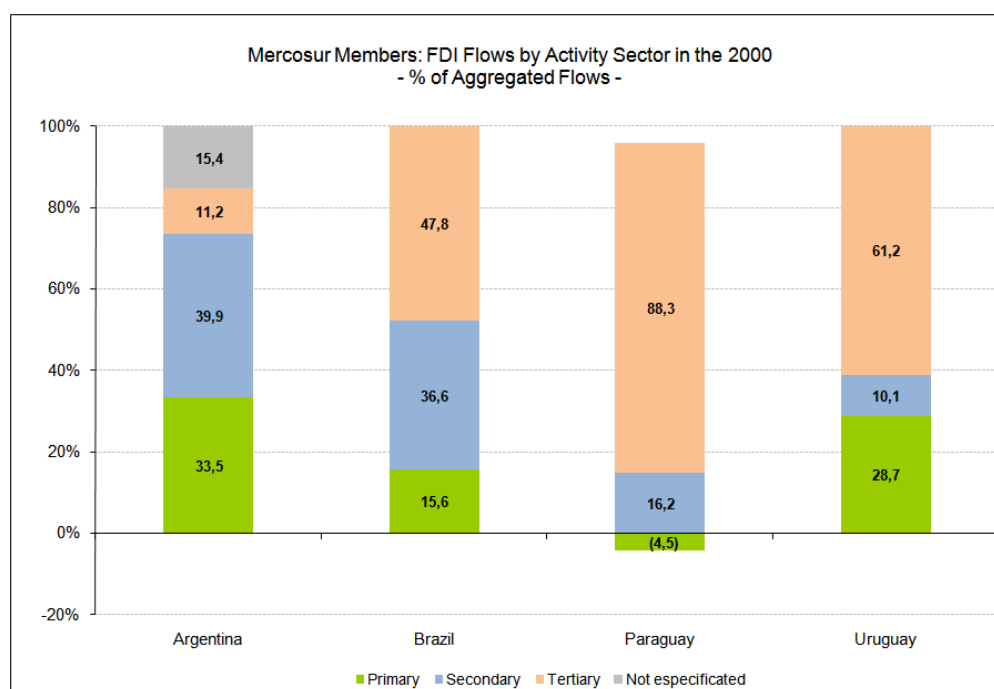


Table A-1

Agro-industry in Mercosur: Selected Indicators

2008

	Argentina	Brazil	Paraguay	Uruguay
GDP (USD Billions)	324,8	1.572,8	16,2	32,2
GDP Real Growth (%)	6,9	5,1	5,8	8,9
Agriculture, hunting, fishing and Forestry (as a % of GDP) 1/	5,8	5,5	27,7	7,2
Agriculture and Agroindustry (as a % of GDP) 1/ 2/ (*)	11,2	9,5	33,9	14,7
Agroindustry (as a % of Industrial GDP) 1/ 2/ (*)	30,9	14,2	49,7	46,0

1/ Based on real GDP

2/ Agroindustry includes: Food, beverages and tobacco, wood and paper.

(*) Figures for Brazil includes alcohol and corresponds to 2007.

Source: Own based on each country National Accounts.

Table A-2

IED Flows: Mercosur members				
Selected Indicators				
<i>FDI as % of flows to Developing Countries</i>				
	Argentina	Brazil	Paraguay	Uruguay
1 990	5,2	2,8	0,2	0,1
1 991	6,1	2,8	0,2	0,1
1 992	8,3	3,9	0,2	0,0
1 993	3,6	1,7	0,1	0,1
1 994	3,5	2,1	0,1	0,1
1 995	4,8	3,8	0,1	0,1
1 996	4,7	7,3	0,1	0,1
1 997	4,8	10,0	0,1	0,1
1 998	3,8	15,1	0,2	0,1
1 999	10,5	12,5	0,0	0,1
2 000	4,1	12,8	0,0	0,1
2 001	1,0	10,5	0,0	0,1
2 002	1,2	9,4	0,0	0,1
2 003	0,9	5,5	0,0	0,2
2 004	1,4	6,2	0,0	0,1
2 005	1,6	4,6	0,0	0,3
2 006	1,3	4,3	0,0	0,3
2 007	1,1	6,1	0,0	0,2
2 008	1,5	7,2	0,0	0,3
2 009	0,8	6,4	0,0	0,2

Source: Own based on UNCTAD and Central Banks.

Table A-3

IED Flows: Mercosur members				
Selected Indicators				
<i>FDI as % of GDP</i>				
	Argentina	Brazil	Paraguay	Uruguay
1 990	1,3	0,2	1,4	0,4
1 991	1,3	0,2	1,4	0,3
1 992	1,9	0,5	1,9	0,1
1 993	1,2	0,3	1,1	0,7
1 994	1,4	0,4	1,8	0,9
1 995	2,2	0,6	1,3	0,8
1 996	2,6	1,3	1,7	0,7
1 997	3,1	2,2	2,7	0,6
1 998	2,4	3,4	4,3	0,7
1 999	8,5	4,9	1,3	1,1
2 000	3,7	5,1	1,5	1,2
2 001	0,8	4,1	1,3	1,4
2 002	2,2	3,3	0,2	1,4
2 003	1,3	1,8	0,5	3,5
2 004	2,7	2,7	0,4	2,4
2 005	2,9	1,7	0,5	4,8
2 006	2,6	1,7	1,0	7,5
2 007	2,5	2,5	1,7	5,6
2 008	3,0	2,8	0,6	5,9
2 009	1,3	1,9	1,3	3,6

Source: Own based on UNCTAD and Central Banks.

Table A-4

IED Flows: Mercosur members				
Selected Indicators				
	<i>FDI as % of Flows to Mercosur</i>			
	Argentina	Brazil	Paraguay	Uruguay
1 990	62,5	33,7	2,4	1,4
1 991	66,7	30,2	2,2	0,9
1 992	66,9	31,1	1,8	0,2
1 993	65,6	30,3	1,6	2,4
1 994	60,0	35,5	2,0	2,5
1 995	54,6	42,9	1,0	1,5
1 996	38,5	59,9	0,8	0,8
1 997	32,1	66,6	0,8	0,4
1 998	19,9	78,7	0,9	0,4
1 999	45,3	54,0	0,2	0,4
2 000	23,9	75,2	0,2	0,6
2 001	8,7	89,8	0,3	1,2
2 002	11,3	87,6	0,1	1,0
2 003	13,5	82,9	0,2	3,4
2 004	18,2	80,2	0,1	1,5
2 005	24,8	71,0	0,2	4,0
2 006	21,3	72,5	0,4	5,8
2 007	15,2	81,2	0,5	3,1
2 008	17,1	79,4	0,2	3,2
2 009	11,2	85,1	0,5	3,2

Source: Own based on UNCTAD and Central Banks.

Table A-5

IED Flows: Mercosur members				
Selected Indicators				
	<i>FDI as % of flows to LAC Countries</i>			
	Argentina	Brazil	Paraguay	Uruguay
1 990	20,5	11,1	0,8	0,5
1 991	21,0	9,5	0,7	0,3
1 992	27,4	12,8	0,7	0,1
1 993	18,4	8,5	0,5	0,7
1 994	12,5	7,4	0,4	0,5
1 995	19,0	14,9	0,3	0,5
1 996	15,0	23,3	0,3	0,3
1 997	12,5	25,8	0,3	0,2
1 998	8,5	33,8	0,4	0,2
1 999	23,0	27,4	0,1	0,2
2 000	10,7	33,6	0,1	0,3
2 001	2,7	27,9	0,1	0,4
2 002	3,7	28,3	0,0	0,3
2 003	3,6	22,1	0,1	0,9
2 004	4,3	19,1	0,0	0,3
2 005	6,9	19,8	0,0	1,1
2 006	5,9	19,9	0,1	1,6
2 007	4,0	21,1	0,1	0,8
2 008	5,3	24,6	0,1	1,0
2 009	3,4	26,1	0,2	1,0

Source: Own based on UNCTAD and Central Banks.

Table A-6

FDI Flows in the host economy, by industry
 USD Millions
 Total for each period

Sector / Industry	Argentina (1992 - 2004)		
	1992 - 2004	1992 - 1998	2003 - 2004
Total	84.520	39.871	5.926
Primary	30.422	5.821	1.987
Agriculture, hunting, forestry and fishing	-	-	-
Mining, quarrying and petroleum	30.422	5.821	1.987
Secondary	19.553	12.713	2.365
Food, beverages and tobacco	5.778	3.550	687
Textiles, clothing and leather	83	147	(2)
Wood and wood products	995	874	132
Other manufacturing	12.697	8.142	1.548
Tertiary	27.423,8	18.060,0	661,8
Electricity, gas and water	9.532	7.610	219
Construction			
Trade	3.662	2.153	77
Hotels and restaurants			
Transport, storage and communications	6.119	2.146	(240)
Finance	8.111	6.151	606
Business activities			
Other services			
Not especificated	7.120,4	3.277,0	911,4

Source: Own based on UNCTAD and Central Banks.

Table A-7

IED Flows in the host economy, by activity sector					
USD Millions					
Cumulated					
Brazil (1996 - 2009)					
Sector / Industry	1996 - 2009	1996-1998	2003-2004	2005-2008	2009
Total	343.216	53.869	33.168	121.344	30.444
Primary	32.484	710	2.560	21.535	4.474
Agriculture, hunting, forestry and fishing	3.022	196	389	1.882	421
Mining, quarrying and petroleum	29.462	514	2.171	19.653	4.053
Secondary	101.655	6.544	15.214	41.326	11.925
Food, beverages and tobacco	19.116	892	5.759	7.018	551
Textiles, clothing and leather	1.851	179	158	1.040	100
Wood and wood products	4.822	127	634	2.753	983
Other manufacturing	75.866	5.346	8.663	30.515	10.291
Tertiary	194.337,1	38.993,0	15.394,1	58.483,0	14.045,0
Electricity, gas and water	25.007	7.472	1.872	5.579	970
Construction	6.595	224	502	3.987	1.165
Trade	26.249	3.779	2.114	9.824	2.832
Hotels and restaurants	1.820	57	246	815	276
Transport, storage and communications	46.161	4.295	6.246	6.695	1.413
Finance	46.420	8.850	1.801	17.911	4.948
Business activities	40.068	14.273	2.397	12.776	2.302
Other services	2.016	43	218	897	139
Not especificated	14.740,0	7.622,0	-	-	-

Source: Own based on UNCTAD and Central Banks.

Table A-8

FDI Flows in the host economy, by activity sector

USD Millions

Total for each period

Sector / Industry	Paraguay (*) (1990 - 2007)		
	1990 - 2007	1990-1998	2004-2007
Total	1.942	1.308	359
Primary	164	161	(16)
Agriculture, hunting, forestry and fishing	164	161	(16)
Mining, quarrying and petroleum	1	1	-
Secondary	603	433	58
Food, beverages and tobacco	446	332	9
Textiles, clothing and leather	5	7	-
Wood and wood products	14	17	-
Other manufacturing	138	76	49
Tertiary	1.168,8	708,8	316,9
Electricity, gas and water	0,6	-	-
Construction	6	9	-
Trade	179	84	55
Hotels and restaurants	25	6	-
Transport, storage and communications	468	296	151
Finance	527	299	166
Business activities	15	10	-
Other services	(52)	4	(56)
Not especified	5,3	5,3	-

* Do not includes information for years 2002 and 2003.

Source: Own based on UNCTAD and Central Banks.

Table A-9

IED Flows in the host economy, by activity sector				
USD Millions				
Cumulated				
Uruguay				
(2001 - 2008)				
Sector / Industry	2001 - 2008	2003-2004	2005-2007	2008
Total	6.750	749	3.670	1.840
Primary	1.906	340	930	604
Agriculture, hunting, forestry and fishing	1.874	340	901	601
Mining, quarrying and petroleum	32	-	29	3
Secondary	774	63	384	261
Food, beverages and tobacco	315	16	123	178
Textiles, clothing and leather	45	2	34	7
Wood and wood products	2	-	-	2
Other manufacturing	412	44	227	73
Tertiary	4.069,6	346,1	2.356,6	975,0
Electricity, gas and water	27,2	(5,4)	17,7	14,9
Construction	1.509	47	785	613
Trade	198	26	61	87
Hotels and restaurants	371	86	130	47
Transport, storage and communications	270	28	166	65
Finance	718	110	266	122
Business activities	62	2	9	50
Other services	915	52	922	(25)
Not especificated				

Source: Own based on UNCTAD and Central Banks.

Table A-10

Railroad Density Total railroad length by country area Selected Countries	
	km by '000 sq km
Germany	117,35
Poland	71,36
United Kingdom	67,54
Italy	65,47
France	45,40
Ukraine	35,88
Portugal	30,25
Spain	30,25
United States	23,04
India	19,26
South Africa	17,12
New Zealand	15,42
El Salvador	13,45
Argentina	11,30
Uruguay	9,31
Mexico	8,92
China	8,11
Chile	7,25
Honduras	6,24
Costa Rica	5,44
Russia	5,10
Australia	4,89
Canada	4,68
Ecuador	3,40
Brazil	3,39
Colombia	3,34
Bolivia	3,19
Guatemala	3,05
Peru	1,55
Panama	1,01
Venezuela	0,88
Paraguay	0,09

Source: Own, based on CIA, The World Factbook.

Table A-11

Land Use Area in 1000 ha.				
	Argentina	Brazil	Paraguay	Uruguay
Country area	278.040,0	851.488,0	40.675,0	17.622,0
Land area	273.669,0	845.942,0	39.730,0	17.502,0
Agricultural area	133.350,0	263.500,0	20.400,0	14.683,0
Arable land and Permanent crops	33.500,0	66.500,0	4.400,0	1.383,0
Arable land	32.500,0	59.500,0	4.300,0	1.350,0
Permanent crops	1.000,0	7.000,0	100,0	33,0
Permanent meadows and pastures	99.850,0	197.000,0	16.000,0	13.300,0
Forest area	32.721,4	471.492,0	18.117,8	1.544,8

Source: Own, based on FAOSTATS

Table A-12

Land Use by Farms Area in 1000 ha.				
Land Use	Argentina 1/	Brazil 2/	Paraguay 3/	Uruguay 4/
Total	164.105	329.942	31.087	16.420
Permanent and Temporary Crops	20.338	59.847	3.365	2.544
Natural and Planted Pastures	103.855	158.754	17.838	12.927
Natural and Planted Forest	35.396	98.480	7.477	949
Other uses	4.515	12.861	2.407	sd

1/ Based on Agricultural Census 2002. INDEC.

2/ Based on Agricultural Census 2006. IBGE.

3/ Based on CAN 2008. MAG.

4/ Based on Agricultural Census 2000. MGAP.

Table A-13
FINANCIAL INDICATORS OF FARMING AND FOOD PROCESSING COMPANIES

**TRAILING PRICE EARNING RATIO: FARMING AND FOOD
PROCESSING INDUSTRIES**

	Obs.	Mean	Standard Dev.	Median
Argentina	7	11.3	6.5	10.1
Brazil	11	76.5	100.9	31.9
Chile	3	22.1	18.0	18.5
South Africa	13	15.5	12.0	11.5
Total	707	58.2	297.1	14.9

Trailing Price Earning: price to annual accumulated earnings.

Table A-14
**RELATIVE PRICE EARNING RATIO: FARMING AND FOOD
PROCESSING INDUSTRIES**

	Obs	Mean	Standard Dev.	Median
Argentina	7	0.56	0.32	0.49
Brazil	11	1.81	2.39	0.76
Chile	3	0.27	0.22	0.23
South Africa	13	1.00	0.77	0.74
Total	707	0.97	3.91	0.36

Relative PE: Firm PE/ Market PE.

Table A-15
BETAS: FARMING AND FOOD PROCESSING INDUSTRIES

	Obs.	Mean	Standard Dev.	Median
Argentina	7	0.58	0.36	0.56
Brazil	21	0.66	0.68	0.63
Chile	9	0.35	0.44	0.09
South Africa	14	0.29	0.28	0.29
Total	928	0.57	0.52	0.48

Table A-16
**MARKET CAPITALIZATION: FARMING AND FOOD PROCESSING
INDUSTRIES**
In MM US\$

	Obs.	Mean	Median.	% World Food sector
Argentina	7	318.1	93.6	0.2%
Brazil	23	1,984.4	352.5	3.4%
Chile	10	129.0	109.2	0.1%
South Africa	15	739.9	417.1	0.8%
Total	1,160	1,171.3	89.0	2.9% (1)

(1) % of the world market capitalization including all industries.

Annex: FDI Norms and Policies

This Annex develops a comparative analysis of regulations governing FDI in MERCOSUR countries. Norms and policies enacted to regulate FDI in each country conform to their legal background and institutional organization. For this reason, the direct access to the norms might be complex and require a cautious interpretation. The information presented here is based on the Laws but also on their interpretation by legal analysts and experts advising on FDI in governmental offices both in host and investing countries (See sources in Reference section)

To facilitate the reading, a brief summary of key issues stemming from the legal comparison for the four countries follows this introduction. Immediately afterwards we present the charts comparing the Laws and regulation by relevant subject:

- i. Legal framework: Degree of openness; National treatment; Special sectors, promoted or banned;
- ii. Regulations on financial and labor contracts Transactions, associated to FDI: Registration requirements; Restrictions on outflows; Labor regulations;
- iii. Dispute Settlement: Method; Multilateral agreements in operation; Bilateral Investment Agreements.
- iv. Economic incentives and protection of property rights: Access to economic incentives: protection of property rights

Chile and South Africa are used as benchmark for the analysis. In terms of FDI, each of these countries are at the end of a range going from extreme openness and friendly climate to foreign investors, the Chilean case, and relatively less liberalized and heavily regulated climate in the South African case.

a. FDI policies

a.1. Synthesis of legal comparison

In this section Tables are presented comparing the four MERCOSUR countries organized by relevant subject

Table A-17
LEGAL FRAMEWORK

	Legal framework	Openness to FDI	Treatment of the FDI	Special sectors
ARGENTINA	Law N° 21382/ 1993 "Ley de Inversiones Extranjeras". Decree 1853/1993	Very open. By law, foreign companies may invest without registration or prior approval. They may participate in publicly funded research and development programs on a national treatment basis.	Foreign and domestic capitals are treated alike.	Restrictions in few sectors to foreign ownership: real properties in national borders, air transportation, shipbuilding, nuclear energy, uranium mining and fishing. Since 2003, limitations to participation in the media of foreign investors were introduced (up to 30% of the equity).
BRAZIL	Law N° 4132/62 "Lei do Capital Estrangeiro"	Very open. Restrictions to foreign ownership in media and communications, aviation, transportation and mining.	A 1995 amendment to the Constitution finished the distinction between foreign and domestic capital.	Media and communications, aviation, transportation and mining. Real properties in the national borders. Participation in banking must be approved by the CB.
PARAGUAY	Law 117/91 and Law 60/90.	The Government of Paraguay encourages FDI.	Most of the sectors are open to FDI and they are treated alike. No formal restrictions to FDI (Law 117/91).	
URUGUAY	Law 16.906/1998 "Promoción y Protección de Inversiones"	National and foreign capital treated alike.	Law 16906, enacted in 1998, declared promotion and protection of national and foreign investment to be in the nation's interest.	FDI in traditional state-owned monopolies is generally not allowed (mainly utilities). In energy and oil production domestic and foreign investment is scarce. In 2004, water was declared a resource under control exclusive by the State.

Table A-18
SOME RESTRICTIONS

	FX transactions	Inflows of FDI	Restrictions on inflows	Restrictions on Outflows	Foreign labor contracts
ARGENTINA	Some quantitative restrictions applied since 2002 to FX transactions.	Registration with the CB.	Registration with the CB. Reserve requirement of 30% and minimum stay for a year apply for most of financial inflows, except FDI, trade credit, IPOs and bond issues. Excluded also are funds to finance energy infrastructure and real estate purchases. Exporters must liquidate their sales in local banks.	Profits and the capital invested can be transfers without restrictions. Subject to monthly quantitative restrictions established by the CB.	Allowed without major restrictions. Visa and legal residence in the country.
	Few restrictions. FX transactions must be reported to the CB. On the current account no restrictions.	Electronic registration with the CB within 30 days of the inflow for FDI. FDI with royalties and technology must register with the patent office (INPI). Investors must have a local representative.	Incoming loans need approval (almost automatic) of the CB. Interests and amortization can be paid without further approval.	Registered foreign investors can remit dividends, capital and royalties. Withholding taxes on remittances of capital gains, lease payments and payments related to transfer technology. FDI profits and long maturity loans are subject to the IOF 0.38% tax. Media and communications are subject to a different treatment.	By Law, two third of employees must be Brazilian.
BRAZIL	Conversion and transfer of foreign currency is unrestricted.	None.	None.	Repatriation of capital and profits are guarantee by Law 60/90.	
PARAGUAY	Transactions in excess of US\$ 10,000 must be reported to the CB.				

	FX transactions	Inflows of FDI	Restrictions on inflows	Restrictions on Outflows	Foreign labor contracts
URUGUAY	Purchases and remittances of foreign currency can be done freely at market rates.	Allowed without prior approval or registration. Foreign investors can transfer capital and profit without restrictions.	None.		No restrictions.

Table A-19

DISPUTE SETTLEMENT AND INTERNATIONAL AGREEMENTS

	Dispute Settlement	Multilateral Agreements	BITs
ARGENTINA	Domestic judicial system may be slow and costly to solve disputes. International arbitration is available.	Member of the ICSID, the United Nations Commission on International Trade Law (UNCITRAL) and of the World Bank's MIGA.	Signatory of BIT agreements with its major trade and investment partners, ratified by the Congress (more than 53). The MERCOSUR Investment Protocol also has been ratified (Laws 24,891 and 24,554).
BRAZIL	Contract disputes in domestic judicial system may be costly and burdensome. By Law the Supreme Court must ratify foreign arbitration awards.	Brazil is signatory of: Inter-American Convention on International commercial Arbitration (1975), Inter-American Convention on Extraterritorial Validity of Foreign Judgments and Arbitration Awards (1979) and the UN Convention on the Recognition and Enforcement of Foreign Arbitration Awards (1958). Brazil is not member of the ICSID. Brazil has not signed the WTO Agreement on Government Procurement.	Signatory of several bilateral agreements but none of them has been ratified by the Congress. The MERCOSUR Investment Protocol also has not been ratified.
PARAGUAY	Enforcement of contracts is costly. Judicial system is not very efficient considering time to solve disputes. International arbitration for disputes between foreign investors and the Government is allowed.	Member of the ICSID since 1982 (ratified by Law). Paraguay ratified all the Uruguay Round accords, including TRIPs and has ratified WIPO treaties. The country is also member of the World Bank's MIGA.	Paraguay is signatory of BITs with Argentina, Brazil, Chile, France, South Africa, Taiwan, United Kingdom and Uruguay. Also, the country is signatory of other investment agreements with other 14 countries. Signatory of the MERCOSUR Investment Protocol (Buenos Aires Protocol, ratified Law 593).
URUGUAY	Investors may choose between arbitration and the judicial system to settle disputes.	Member of the ICSID (2000) and World Bank's MIGA.	Signatory of 27 BIT agreements with its major trade and investment partners, ratified by the Congress. Signatory of the MERCOSUR Investment Protocol (Buenos Aires Protocol, ratified Law 17,531).

Table A-20
INCENTIVES AND PROTECTION OF PROPERTY RIGHTS

	Performance Requirements and Incentives	Protection of Property Rights	Other Comments
ARGENTINA	Same treatment national and foreign capital. VAT refunds and accelerated depreciation of capital goods and tariff incentives for production of capital goods. Special programs (e.g. Automotive industry), FTZ, etc. No special performance requirements must be fulfilled by foreigners. Regime of the automotive industry, for instance, requires some national minimum-content standard.	Argentina is signatory of most of the treaties and adheres to the WIPO and the WTO. Congress ratified the Uruguay Round Agreements, including provisions on intellectual property. However, protection for pharmaceutical products and genetically modified seed has been a source of controversial with other countries. Bankruptcy law similar to US Chapter 11.	Tax stability guaranteed by law to mining companies has been modified by the federal government. Also, the Government has moved to a deeper intervention in domestic markets, especially related to grains and food processing. These measures not discriminate against foreign companies.
	Basically there are not differences between foreign and domestic capital. Tax incentives and programs for investment in less developed and marginal areas. For domestic and foreign capital as well. At state level, ad hoc benefits offered by some states, case by case. Exporters are subject to tax breaks. Some sectors can apply for tax credits for capital goods purchases. BNDES and FINAME offer loans to purchase capital goods with high level of domestic content. Federal, State and municipal governments tend to follow the "buy domestic" policy for procurement. Stringent requisites for foreign bidders of IT goods and services. Other lines of credit available from state-funded BNDES, FINAME and PROEX.	Signatory of TRIPS Agreement (1994), member of the WIPO and other agreements. Some WIPO has not been ratified. Industrial Property Law according to international standards. Compulsory license is allowed. Bankruptcy law similar to the US Chapter 11.	None.
BRAZIL			

Performance Requirements and Incentives	Protection of Property Rights	Other Comments
<p>Paraguay's tax burden is very low: 10% basic corporate tax and a 10% VAT on most of goods. Maquila operations are encouraged by a special law. Tax breaks also are offered to investors (Law 60/90). However, voting board members of any company incorporated must have residence legal (obstacle to FDI). Also the Law protecting agents and distributors (Law 194/93) may discourage FDI due to the overly protection of local counterparts.</p>	<p>Private property is fully respected. However, there were several cases of expropriation of land without prompt compensation over the past few years, some of them from foreigners. Inefficiency in registries and property surveys make difficult to foreclosure. For the same reason, acquiring titles for land can take years. There is a lack of enforcement of Intellectual Property Rights, becoming Paraguay regional center of counterfeit merchandise. As a consequence of the lack of a legal framework for confidential data protection, some pharmaceutical products have not been marketed domestically.</p>	<p>Paraguay ranks very low regarding corruption and transparency. The country ranks 138th out of 179 countries in Transparency International Corruption Perceptions Index from 2008.</p>

	Performance Requirements and Incentives	Protection of Property Rights	Other Comments
URUGUAY	<p>Legislation considers local and foreign investors alike regarding tax credits, grants or special access to credit. Foreign investors do not need to meet special performance requirements. Tax incentives for personnel training, R&D, reinvestment of profits and investments in capital goods. Special regimes for manufacturing, domestic trade, services, tourism, forestry and citrus plantation. etc. None of them discriminate between foreign and domestic. Also discretionary benefits, subject to GOU approval of an investment plan, included tax breaks, reimbursement of VAT and other exemptions. Other incentives include accelerated amortization for investment (Decree 414/07). Procurement tends to favor local products and services. Foreign firms are able to participate in public-funded programs for R&D finance and subsidies. Also there are FTZ, available for domestic and foreign companies. Ownership of land by foreign companies must be identified.</p>	<p>Uruguay is a member of the WIPO and is signatory of most of the international treaties related to intellectual property. Also, the patent law allows compulsory license.</p>	<p>None.</p>

a.2. Comments on legal comparison by country.

BRAZIL

Over the last few decades, FDI has played a relevant role in the Brazilian industrialization process, mainly attracted by the large domestic market and the government policies. Both the capital and technology-intensive manufacturing activities were the sectors chosen by foreign investors. More recently, in the 90s, the service sector was a key activity in FDI inflows.

In spite of being one of the main recipients of FDI among emerging countries, Brazil does not have any bilateral investment agreement in effect. The only two commitments are the OMC and the Trade-Related Investment Measures Agreement (TRIMs) given that even those bilateral investments agreements signed during the 90s have not yet been ratified by Congress.

The basic legal framework related to foreign investments remained stable over time despite the political instability that characterized Brazil between the 60's and the 80's. It was established by

Law 4.131, which put in place exchange controls, a new tax regime, etc. The aim was to discourage the outflow of foreign capital invested in the past and to encourage the re-investment of earnings. There were also some restrictions to FDI in some specific sectors of the industry (e.g. mining), but they were relatively more relevant and long-lasting in services (da Motta Veiga, 2004).

Regarding FDI in manufacturing sectors, they were not subject to restrictions except in certain sectors that the government held to be strategic, there conditionalities, such as requirements of joint ventures or technology transference were applied.

The 1988 Constitution introduced several restrictions to FDI but to the national private investment as well. In fact, Article 171 made the legal distinction between companies “of national capital” and “of foreign capital”. This difference implied that, for instance, only those companies of national capital could undertake the exploitation of mineral and water resources, coastal navigation, domestic air transportation, and media activities. Also there were restrictions for foreign companies to invest in financial and technology sectors.

After liberalization reforms in the 90s various limitations were revised. For instance, restrictions on IT and financial sector investments to foreign companies and on outflows were lifted or relaxed. Also, the participation of private companies, no matter whether foreign or national owned, was allowed in the telecoms and in gas and oil areas. The latter change would enable foreign companies to participate in future biddings in public services concessions among other opportunities.

Together with these institutional modifications, some other instrumental measures were carried out during the 90s. Although a generalization of “horizontal” industrial policies was common during the nineties, some sectors received special treatments. These were the automotive industry, the information technology activity and the textile sector.

Multilateral agreements: Negotiations on investment protection have developed at the multilateral and regional levels, especially in bilateral relations. These agreements intend to protect investments and to liberalize the national regimes applicable to FDI flows. The commitments assumed by Brazil so far were those derived from the Uruguay Round agreements. Brazil has signed 24 bilateral agreements with the objective of preventing double taxation, and others 24 bilateral investment agreements with the OECD and other developing countries. The MERCOSUR protocols and bilateral agreements have not been ratified by the Congress, yet.

Besides the commitments assumed in the TRIMs agreement, Brazil made other commitments under the GATS agreements. The sectors especially targeted were services such as construction and engineering, financial services and tourism. Broadly considered, the commitments signed were less restrictive in national treatment than in market access which exemplifies the Brazilian preference for consolidating a situation of non discrimination to foreign suppliers active in the domestic market rather than the promotion of new incoming foreign companies.

MERCOSUR agreements: During 1994, the four members of the MERCOSUR signed the Protocol for the Promotion and Protection of Investments from Non-Member Countries (known as the Buenos Aires Protocol) and a few months later the Protocol for the Promotion and

Protection of Investments of Member-Countries (the Colonia Protocol). None of them came into effect given that they were not ratified by the Member States.

The characteristics of these agreements are the following:

- The concept of investment is based on the asset definition. This includes direct and financial investments.
- They provide for national and most-favored-nation treatments of the various member-states and third-party countries.
- These obligations do not extend to tax matters covered by specific double-taxation agreements nor do they apply to sectoral exceptions admitted for a non-specified transitory period.
- Performance requirements, such as export or national content, are banned under the Colonia Protocol but Argentina and Brazil have reserved the right to preserve temporarily those requirements in the automotive industry.
- Nonetheless, the member-states did not assume any commitment related to performance requirements to third-party States in the Protocol of Buenos Aires, other than those already assumed in the WTO Agreements on TRIMs.
- The Colonia Protocol is explicit in authorizing divergent national treatments for intra-regional investors. That is, in its Art.7, establishes the possibility of a member State granting an intra-regional investor more favorable treatment than what the Protocol provides (Bouzas, 2003).
- Both Protocols provide mechanisms for settling disputes opposing investors and contracting parties. For intra- MERCOSUR investments, the provision is to seek a solution through “friendly consultations”. If the dispute remains unsolved, it will be submitted to one of the following three procedures, at the criterion of the investor: the courts of the host country, international arbitration or any private system of dispute-settlement to be established. For extra-MERCOSUR disputes, the Buenos Aires Protocol provides the first two options.

Openness to FDI: Very open although certain sectors face ownership limitations: media and communications, aviation, transportation and mining. The Government of Brazil makes no discrimination between foreign and national capital since the beginning of the nineties.

Tax and regulatory requirements, although sometimes excessive, do not make differences between FDI and domestic investment.

Restrictions on FDI: A 1995 amendment to the Constitution finished the distinction between foreign and domestic capital thus prevailing in the fundamental rule of the country. Yet there are laws that restrict foreign capital in media and communications and aviation, particularly.

Restrictions to capital inflows and outflows- Conversion and Transfer policies: Few restrictions apply. All foreign exchange transaction must be reported to the Central Bank. On the current account there are not restrictions. FDI must register the investment with the CB within 30 days of the inflow resources to the country. The registration must be done electronically. FDI with royalties and technology transfer must be registered with the patent office (INPI).

Investors must have a local representative.

Financial matter: Loans granted and entering the host country must be approved by the CB but generally this is automatic. Interest and capital payments which were specified in the loan contract can proceed without additional authorization. Even payments in advance do not require a new approval unless they were not specified in the contract.

Foreign investors already registered in the CB are able to remit dividends, capital – including capital gains- and royalties. Remittances can be made to any bank documenting the source of the transaction and that fiscal obligations have been complied.

Capital gain remittances must pay a 15% income withholding tax, although there exemptions from gains accrued to some Brazilian bonds. Repatriation of an initial investment is exempt of income tax. Lease payments are subject to a 15% withholding tax.

Payments related to technology transfers are not subject to the tax on credit, foreign exchange and insurance (IOF⁶⁰) although they are subject to a 15% of withholding tax and an extra 10% Contribution of Intervention in the Economic Domain (CIDE)⁶¹. Loans with terms of 90 days or less must pay the IOF (5.38%). Longer maturity loans, profits and FDI remittances are subject to the IOF 0.38% tax.

Cable and satellite TV programmers owned by foreigners have a different treatment. They must pay 11% remittance tax unless these companies invest 3% of the remittances in domestic production.

Dispute settlements and international agreements: The Brazilian judicial system suffers from the same problem as the rest of countries in the region. That is, contract disputes may take a long period of time to move through the system. However, some judicial reforms undertaken in 2004 have eased some administrative procedures.

Law 9.307 established that the Supreme Court must ratify foreign arbitration awards. Foreign awards must be applied in conformity with the international agreements ratified by the country or by the domestic law if the former does not exist. Brazil has ratified the 1975 Inter-American Convention on International Commercial Arbitration, known as Panama Convention), the 1979 Inter-American Convention on Extraterritorial Validity of Foreign Judgments and Arbitration Awards (Montevideo Convention) and the 1958 UN Convention on the Recognition and Enforcement of Foreign Arbitration Awards (New York Convention). Brazil is not a member of the International Center for the Settlement of Investment Disputes (ICSID).

Inspired by the Chapter 11 of the US bankruptcy code, in February 2005 the Brazilian law was reformed (Law 11.101) which allows a company in financial problems to negotiate a restructuring with its creditor outside the courts and, eventually, the law gives creditors improved ability to recover their debts.

Incentives and protection of private property- Performance requirements and Incentives

⁶⁰ Imposto sobre Operações de Crédito (IOF).

⁶¹ Contribuição de Intervenção do Domínio Econômico – CIDE Remessas Exterior - Lei 10.168/2000

The Brazilian State actively encourages national and foreign investment in underdeveloped regions and in marginal areas. The Public-Private Partnership (PPP) law, approved in 2004, promotes joint ventures in infrastructure in those areas⁶². In 2007, Brazil announced the Program to Accelerate Growth (PAC) trying to incentive private investment in infrastructure using public funds but the implementation has been slow.

There are tax incentives for investment in the less developed area of the country – Amazon and Northeast regions- offered by the Federal Government. These benefits can be used by domestic as well as foreign capital.

At the state level, some states have offered ad hoc benefits and infrastructure support to specific companies, although negotiated on a case by case modality.

Exporters are subject to tax credits (Law 11.529 enacted in October 2007), to improve their competitiveness. Textiles, furniture, shoes, leather goods, heavy and agricultural machinery manufacturers, apparel and automotive and auto parts, among other sectors, can apply for tax credits⁶³ for the purchase of capital goods, domestic or imported. The law also extends the benefit to those companies who derived 60%-70% of their revenues from exports.

The special agency for industrial financing (FINAME) of the National Bank for Economic and Social Development (BNDES) provide financing for Brazilian firms to purchase capital goods subject to conditions on domestic content.

Brazil has not signed the WTO Agreement on Government Procurement. Some analysts have recommended the improvement of transparency of the process of procurement. Governments at Federal, State and municipal levels follow in general a prudent “buy domestic” policy.

The Law 8.666, enacted in 1993, rules most of the aspects related to procurement. The law requires non-discriminatory treatment regardless nationality or origin of the product. However, the regulation of the law allows for the consideration of non-price factors, preference for goods produced in Brazil and the conditions on local content requirements for fiscal benefits eligibility.

Even more stringent are the requisites for foreign bidders to provide IT goods and services⁶⁴. Foreign companies with legal entity in the country are allowed to compete for procurement whenever they are related to multilateral development bank loans and opened selected procurement to international tenders.

Protection of Property Rights: As for mortgages, in Brazil there is a system of registries but it is implemented unevenly. Also, there is not standardized contract. Real state can be owned by foreign capital. Both, the primary and the secondary mortgage market are not very well developed.

⁶² Although the evidence seems to indicate that the application has been scarce.

⁶³ Tax credits on PIS (Social Integration Program) and Cofins (Contribution for the Financing of Social Security) taxes.

⁶⁴ Decree 1070, enacted in 1994.

The GATT Uruguay Round Agreements, including the TRIPS Agreement (Trade Related Aspects of Intellectual Property), were signed in 1994. The country is member of the World Intellectual Property Organization (WIPO) and other agreements related to intellectual property rights. However, some WIPO treaties have not been ratified, for instance, the Copyright Treaty.

The Brazilian Industrial Property Law (Law 9.279) brings its patent and trademark regime in accordance with the international standards although some flaws remain. For example, there exists the possibility of compulsory license under certain conditions. One controversial issue is the protection of intellectual property of pharmaceutical products for human use. For example, the Government of Brazil recently issued a compulsory license for a drug used in the HIV/AIDS based on the public interest and invoking TRIPS provisions.

Regulations: Tax regulations may be complicated in Brazil. However they do not differentiate between local and foreign capital.

Credit support: The government national development bank, BNDES, is the main source of long-term loans and also offers credit for exporters. The agency specialized in industrial financing, FINAME, grants loans for the production, marketing and exports of capital goods. PROEX is a program financed by the Treasury in order to lend funds for exporters.

Antitrust policy: Acquisitions resulting in market share higher than 20% of the market are subject to review by the Administrative Council for Economic Defense (CADE) under the Brazil's 1994 Anti-trust law.

Corruption: In 2008 Brazil ranked 80th out of 180 countries in Transparency International's Corruption Perception Index. Brazil is signatory to the Organization for Economic Cooperation and Development (OECD) Anti-Bribery Convention.

ARGENTINA

Openness to FDI: Argentina is open to foreign capital. According to the Law of foreign investment, Decree 1853, companies from abroad may invest in Argentina without registration or prior approval. Foreign capital is treated on the same bases as domestic capital. Foreign firms may participate in publicly funded research and development programs on a national treatment basis.

Argentina is signatory of BIT with several countries. Broadly speaking, these agreements provide protection to investors against capital movement restrictions, expropriations, performance restrictions and establish streamlined dispute settlements. There are some restrictions to foreign capital in a few sectors, depending on the BIT: real state in national border areas, air transportation, shipbuilding, nuclear energy, uranium mining and fishing.

Taxes on foreign and domestic companies are the same. Some of the investment promotion programs include VAT refunds and accelerated depreciation of capital goods and tariff incentives for production of local capital goods. There are also some sector programs (for instance, for the automotive industry), Free Trade Zones, SME promotion, etc. They are available to nationals and foreign investors alike.

Conversion and Transfer Policies: Some regulations on exchange rate transactions are applied since 2002. In fact, inflows and outflows must be registered at the Central Bank. Argentine residents as well as institutional investors are restricted to net currency purchases up to US\$ 2 million per month.

As for inflows of capital, they must comply with some strict requirements according to the following categories (Decree 616): those derived from private sector loans (excluding IPOs, bond issues and foreign trade), for most fiduciary funds, inflows of nonresidents (excluding FDI and for IPOs) and purchase of public debt in secondary markets. In fact, these funds must stay in the country for at least 365 days, the conversion of inflows to pesos must be done to an account in the financial system and they are subject to an unremunerated reserve requirement of 30% of the capital for one year. Besides IPOs, bond issues, trade credit and FDI, are also excluded of these regulations those funds directed to finance energy infrastructure and purchases of real estate property by foreigners.

Since October 2008, exporters are obliged to deposit funds of external sales and trade credit in branch offices of local entities within 10 days after completing the operation (Com.A 4860 BCRA).

Expropriation and Compensation: Private property is guaranteed by the Argentine Constitution (Art. 17). Expropriation must take place prior approval of the Congress and prompt proper economic compensation.

Dispute settlement: Argentina is a member of the International Center for the Settlement of Investment Disputes (ICSID), the United Nations Commission on International Trade Law (UNCITRAL) and of the World Bank's Multilateral International Guarantee Agency (MIGA).

During the 2001-2002 macroeconomic crisis, amid high inflation and a drastic drop of the domestic currency, public utilities' tariffs were frozen in nominal pesos hurting private profitability. Since that time, several companies have filed against Argentina in the ICSID and there are 34 cases still pending. The consequences of this crisis also reached the provisions of Bilateral Investment Agreements affecting the credibility of this instrument in the Argentine case.

Argentina has a strict bankruptcy law, including provisions similar to the Chapter 11 of United States.

Performance requirements and incentives: No special performance requirements must be comply by foreign investors. In some special regimes national minimum-content standards are required (for instance automotive industry) and also quotas or special tariffs.

Right to Private ownership and establishment: Foreign and domestic investors have free and equal rights to operate and to own businesses.

Protection of Property rights: Mortgages and other private property are widely recognized in the country. Argentina is signatory of most of the treaties and agreements on intellectual property and adheres to the World Intellectual Property Organization (WIPO) and the World Trade

Organization (WTO). The National Congress ratified the Uruguay Round Agreements, including the provisions on intellectual property.

However, patent protection has been a source of controversy with some developed countries due to alleged inadequate implementation and interpretation. These have been the cases of pharmaceutical products for human use and of the genetically modified seeds.

Although the Argentine copyright law dates back to 1930, it provides a good legal framework to protect intellectual property. However the piracy of CDs, DVDs and software is rampant in spite of the many actions taken by the Government. The country provides also a legal protection for trademarks.

Transparency of regulatory system: Since 2002, several economic measures have been taken by the Government of Argentina to avoid inflation in energy costs. Besides the frozen of utilities' tariffs, the government imposed taxes on exports and retail price controls on the energy industry (oil and natural gas). This has created a high degree of uncertainty and conflict between energy producers and the government, a sector with important foreign companies as participants.

Also, in late 2007 the Government moved to end export tax exemptions for mining companies collecting federal levies on them. This constituted an abrupt change of the tax stability guaranteed by a law enacted in 1993 for mining companies. Many of the affected companies sought to redress the discussion in the courts.

Capital markets: Accounting standards are compatible with international norms. Capital markets are not fully developed. At present, they exhibit low capitalization and liquidity. The nationalization of private pension funds in late 2008, until then the main institutional investors, provoked a collapse of daily trading volumes in stock markets.

Corruption: Argentina is down in the table of the perception of corruption ranking. In fact, the Transparency International (TI) index ranked Argentina in the position 109 out of 180, below most of the Latin America countries.

Argentina is member of the OAS Anti-Corruption Convention and also signatory of the OECD Anti-Corruption Convention. The country has signed and ratified the UN Convention Against Corruption (UNCAC).

Bilateral Investment Treaties: Argentina is signatory of bilateral investment protection agreements with its major trade and investment partners. Congress has ratified all of them.

The country has double taxation treaties with Australia, UK, Denmark, Germany, Belgium, Austria, France, Italy, Sweden, Switzerland, Spain, Canada, Chile, Bolivia, Brazil, Finland, Norway and the Netherlands.

OPIC and other insurance programs: Argentina is signatory of an agreement with the Overseas Private Investment Corporation (OPIC) and member of the World Bank MIGA.

URUGUAY

The Government of Uruguay encourages FDI. There are neither restrictions nor discrimination toward foreign investment. In 1998, the GOU enacted Law 16.906 that declares that the promotion and protection of national and foreign investment is in the nation's best interest. The Law states that foreign and national investments be treated alike, investments are allowed without prior authorization or registration, the government will not prevent the establishment of investment in the country and, finally, investor may freely transfer abroad capital and profits from the investment.

Since the enactment of the of Decree 414/07, investors are offered streamlined procedures for firms requesting tax exemptions, and established a single-window mechanism to channel requests and guide investors.

Law 18092 which passed in 2007 requires corporations that purchase land to use registered shares held by individuals (rather than bearer shares). This legislation caused foreign investors to put their plans on hold. However, the GOU later exempted some large foreign companies from this requirement.

In general, to set up operations firms are not required to prior authorization from the government. Financial transactions in any particular currency also may be done freely. Also there are no restrictions on technology transfer.

With the exception of traditionally state-owned monopolies, there are not sectors where foreign capital can not invest.

Investors may choose between arbitration and the judicial system to settle disputes. Uruguay is a member of the ICSID since 2000. Uruguay is signatory of more than 27 BITs with its major trade partners. The country ratified the investment protection protocol for investors from extra-MERCOSUR, known as Buenos Aires Protocol (Law 17,531, passed in 2002).

Regarding performance requirements, foreign investors are not required to meet any specific requirements.

The GOU grants two types of benefits to investors, namely, automatic and discretionary. The former applies to personnel training, research and scientific and technological development, reinvestment of profits and investment in capital goods. There are also sector incentives to promote manufacturing, domestic trade, services, tourism, forestry and citrus plantations, among others. None of these regimes treat the foreign investor differently.

Discretionary incentives require investors to submit an investment plan in order to be approved by the Government. Also, in this case national and foreign capitals are treated alike. These benefits include tax exemptions on imports of fixed assets, reimbursement of VAT on local purchases of goods and services for construction and significant exemptions from corporate income tax. Decree 414/07 broadens the base of firms reached by fiscal incentives, including also investment expenses deduction of income tax. The size of the benefit depends on a list of criteria, including the generation of jobs, contribution to innovation, exports, regional spillovers, etc.

Procurement is to some extent restricted for foreign suppliers. In fact, the GOU tenders must favor local products and services, according to the legislation, provided that quality is similar and they do not exceed in 10% to the price of foreign ones.

Uruguay is a member of the WIPO (World Intellectual Property Organization) and also of other similar conventions. In 1998 the country passed trademark law and in 1999 a new patent legislation. A new copyright law was enacted in 2003.

Free-Trade Zones (FTZ) are regulated by Law 15,591 passed in 1987. FTZs permit all types of commercial, manufacturing, industrial and service activities. Free trade zone tenants are exempted from all domestic taxes as well as from custom duties. These benefits are available for foreign and domestic investors.

PARAGUAY

The Government of Paraguay guarantees equal treatment of foreign investors and there are no formal restrictions on foreign investment.

Law 117/91 guarantees national treatment of FDI and freely transfers of capital and profits by Law 60/90.

Basic corporate income tax is currently 10% and VAT of 10% is applied on most of goods and services.

The operation of maquilas – companies that process goods or services for export- are subject to a different legal framework (Law 1,064/97). Value added in maquilas must pay a tax of 1%, inputs are allowed to enter the country free of taxes and up to a 10% of production is permitted for local consumption (paying taxes). Maquilas are not restricted geographically or by industry. Since 2005, citizens from Argentina, Brazil and Bolivia are forbidden to own land within 50 kilometers of the national borders.

The GOP does not restrict the conversion or transfer of foreign currency. Only reporting of operations in excess of US\$ 10,000 is required. Law 60/90 permits the full repatriation of capital and profits.

National treatment for foreign investors is guarantee by Law 117/91. This legislation allows international arbitration for the resolution of disputes between foreign investors and the government.

Fiscal incentives are offered to investors, mainly tax breaks.

It must be noted that two legal requirements might prevent foreigners to invest in Paraguay:

- a) Voting board members of any company incorporated in the country are obliged to have legal residence.
- b) Law 194/93 features strong penalties for severing relations with local distributor or agents. This has caused some costly out-of-court settlements.

The lack of consistent property surveys and registries may make difficult to redeem guarantees by foreclosure.

Paraguay ratified all the Uruguay Round accords, including TRIPS and has ratified two WIPO copyrights treaties. However, the enforcement of intellectual property rights (IPR) is weak, given that most of the main distributors and producers of counterfeit merchandise in South America are located in the country. IPR crimes are concentrated particularly in Ciudad del Este, a city on the border with Argentina and Brazil.

Paraguay is signatory of BITs with Argentina, Brazil, Chile, France, South Africa, Taiwan, United Kingdom and Uruguay. The country also has signed other 14 investment agreements. Paraguay is member of the ICSID since 1982.

The country ratified the investment protection protocol for investors from extra-MERCOSUR, known as Buenos Aires Protocol (Law 593, passed in 1995).

b. Industrial policies and FDI

The previous section has included many of the relevant effects of industrial policies on FDI by country. Thus in this section we concentrate on the role of country agencies which have been organized with the purpose of attracting FDI.

ARGENTINA

ProsperAR. Invest in Argentina.

ProsperAr is the Argentina's Investment Development Agency, a decentralized agency depending on the Ministry of Economy and Production. Their goals are:

- a) To support the positioning of Argentina as a highly attractive market for domestic and foreign investments.
- b) To plan and execute tools and instruments for the promotion and development of investments.
- c) To participate in the drafting of instruments aimed at the expansion of foreign trade and the internationalization of local companies.
- d) To participate in MERCOSUR negotiations as well as in other international negotiations, regarding matters under its scope.

Fundación Invertir.

Non –profit private organization aims to promote investment in Argentina. It offers information about procedures to invest, regulations, legislation, opportunities, etc.

BRAZIL

APEX

The Brazilian Trade and Investment Promotion Agency (Apex-Brasil) has several goals, including the promotion of exports, the development of the internationalization of Brazilian companies and the attraction of foreign investment into the country.

According to its website, at the moment Apex-Brazil gives support to over 70 sectors of the Brazilian economy, ranging from agribusiness to machines, technology, architecture and civil construction, entertainment and services to fashion and industrial equipment. The Agency develops and builds the image of these productive sectors by means of solid marketing activities and publicity campaigns directed to entrepreneurs and consumers of highly potential purchasing power. Every year, Apex-Brazil provides assistance to Brazilian companies' participation in more than 600 events – both in Brazil and abroad.

In order to strengthen the internationalization of Brazilian companies, the Agency has Business Support Centers that provide an excellent supporting services' structure. Located in Miami, Dubai, Warsaw, Havana, Peking and Moscow, these Centers provide assistance to companies interested in opening subsidiaries abroad in order to maintain goods and merchandise inventories, showrooms or regional offices.

RENAI

The National Investment Information Network - RENAI - is an information network on the investment activity in Brazil, supported by the Ministry of Development, Industry and Foreign Trade - MDIC - with the assistance of partners such as state organs of incentive to investments as well as the entrepreneurial class entities.

CHILE

Foreign Investment Committee

The Foreign Investment Committee is the agency that represents the State of Chile in its dealings with those investors who choose to use the Foreign Investment Statute (DL 600) as the legal mechanism for bringing foreign direct investment (FDI) into Chile.

The Foreign Investment Committee is formed by the Ministers of Economy (who acts as president of the Committee), Finance, Foreign Relations and Planning as well as the president of the Central Bank. Other ministers responsible for specific economic sectors are also invited to participate in meetings whenever deemed necessary.

Missions: To help position Chile as a highly attractive destination for foreign investment and international business through its operational role in administering matters related to the corresponding legal norms, by developing promotional activities of different types and by participating in international negotiations.

CORFO. Invest Chile.

CORFO is the Chilean Economic Development Agency, a governmental organization founded in 1939, to foster economic growth in Chile by encouraging investment, innovation, business and cluster development.

CORFO created the *InvestChile* program in 2000, to encourage foreign investment. The focus of *InvestChile* is mainly on technology intensive foreign investment and to assist companies looking to relocate to Chile. This program offers a series of incentives, services and comprehensive information regarding business opportunities in various sectors of the Chilean economy.

InvestChile is comprised of 13 offices within Chile and is represented abroad in Spain, Italy, Sweden, the United States, and Canada. It possesses US\$3.9 billion in capital combined with US\$4.0 billion in assets. Of these assets, US\$2.0 billion corresponds to investment in companies in which the State of Chile participates directly through CORFO. CORFO annually assists more than 32 thousand Chilean businesses (mainly SMEs). It also grants around US\$127 million in loans through the private financial system, banking or non banking, and around US\$81 million in subsidies (an amount that enables business support to upwards of US\$68 million).

URUGUAY

Uruguay XXI

Uruguay XXI, the Investment and Export Promotion Institute, helps to internationalize the Uruguayan economy. To accomplish this aim, the institute looks for to attract foreign investment and to promote exports. It offers information for the investor and the exporter.

Uruguay XXI was created in 1996 as a company to provide business services to suit the needs of foreign and domestic clients.

SOUTH AFRICA

Department of Trade and Industry

Among the key strategic objectives of the DTI are: a) to promote direct investment and growth in the industrial and services economy, with particular focus on employment creation; b) to contribute towards the development and regional integration of the African continent and; c) to raise the level of exports and promote equitable global trade.

The DTI offers in its website information about regulations, procedures, legislation and opportunities of investment.

PARAGUAY

Invertir en Paraguay

The Ministry of Industry and Trade offers information about procedures, regulations, legislation and opportunities to invest in Paraguay.

Table A-21

SUMMARY: AGENCIES AND MINISTRIES RELATED TO FDI ATTRACTION

Country	Agency	Property	Website
Argentina	ProsperAR - Invest in Argentina	Public	www.prosperar.gov.ar
	Invertir	Private association	www.invertir.org.ar
Brazil	RENAI	Public	http://sistemasweb.desenvolvimento.gov.br
	Brazilian Trade and Investment Promotion Agency – Apex	Public	http://www.apexbrazil.com.br
Paraguay	REDIEX	Public	http://www.rediex.gov.py/
Uruguay	Uruguay XXI Investment and Export Industry	Public - Private	http://www.uruguayxxi.gub.uy
Chile	Foreign Investment Committee	Public	http://www.foreigninvestment.cl/
	Invest in Chile - CORFO	Public	http://www.todochile.cl
South Africa	The Department of Trade and Industry (DTI)	Public	http://www.thedti.gov.za/

c. International experience

Chile and South Africa

Chile and South Africa (SA) use a very different approach to encourage FDI. While Chile offers to sign a contract to foreign investors, SA treats FDI in a similar way to the one of MERCOSUR countries although under more regulations. The following tables present both cases and the information is organized to facilitate comparison with the previous information on the MERCOSUR countries.

Table A-22
LEGAL FRAMEWORK IN COMPARATIVE COUNTRIES

	CHILE	SOUTH AFRICA
Legal Framework	Decree Law N° 600 "Estatuto de la Inversión Extranjera". For financial investments, Chapter XIV of the Central Bank's Compendium of Foreign capital into Chile.	Acts compiled in "Investor's Handbook" of the Department of Trade and Industry (DTI).
Openness to FDI	Very open. One of the main driver of the Chilean economic success.	South Africa encourages FDI. Trade and Investment South Africa (TISA) is the investment agency.
Treatment of the FDI	Foreign investors receive national treatment in nearly all sectors. Each foreign investor must sign a contract with the Foreign Investment Committee (FIC). This contract entitles investors to receive non-discriminatory treatment, to remit or reinvest earnings immediately and to remit capital after one year, to opt from either national tax treatment or for a higher guaranteed tax rate, among other benefits. Alternatively, under the Chapter XIV some of these benefits are not available (e.g. guarantee tax rate).	National and foreign capital are treated alike.
Special Sectors	Limits to foreign investors participation in Chilean fishing companies or media, except with countries with a reciprocity agreement (e.g. The European Union).	Restrictions in banking and defense related sectors.
FX transactions	Companies under contract are authorized to buy foreign currency at the inter-bank rate.	Local and foreign companies must be authorized by the CB to make a transaction.
Restrictions on inflows	Companies under contract are authorized to buy foreign currency at the inter-bank rate.	Local and foreign companies must be authorized by the CB to make a transaction.

Table A-22 (cont.)

LEGAL FRAMEWORK IN COMPARATIVE COUNTRIES

	CHILE	SOUTH AFRICA
Restrictions on outflows	FDI must send an application to the FIC. Applications are usually approved within a month. Rejection of applications by FIC is limited by the Constitution. Other related financial transactions must be approved by the CB. Foreign investors must request a maximum time to implement their projects. If more favorable law is enacted after signatory of the contract, the company has the right to be amended. Under Chapter XIV, only is necessary to inform the CB.	Must be reported to the CB.
Restrictions on inflows	Since 2002, there are not controls on flows of foreign capital (inflows and outflows).	Must be reported to the CB.
Restrictions on Outflows	Only if the company signed a contract with the FIC, it must stay the capital for a year. Payments of royalties and patents in excess of 5% of sales may be denied access to the inter-bank currency market.	Companies can remit freely capital, profits, interest and royalties for the use of know-how, patents, designs, trademark or similar property (with prior approval of the CB). When payments of royalties and license fees were due to local manufacturing, DTI must approve the transfer.
Foreign labor contracts	For companies with more than 25 employees, the Law requires that 85% of them, at least, being Chilean citizens.	In the financial system a percentage of South African is required. A 2% tax on expatriates salaries since 2003.

Table A-23
DISPUTE SETTLEMENTS AND INTERNATIONAL AGREEMENTS IN
COMPARATIVE COUNTRIES

	CHILE	SOUTH AFRICA
Dispute Settlement	International arbitration is allowed by Law. Judicial system is considered transparent and efficient for contractual disputes.	International arbitration is recognized and enforced. Judicial system is considered independent and transparent.
Multilateral Agreements	Member of the ICSID (1991) and World Bank's MIGA.	South Africa is a member of the New York Convention of 1958 recognizing foreign arbitration awards. The country is not member of the ICSID.
BITs	Chile is signatory of a Free Trade Agreement (FTA) with the U.S.A. Also, the country has signed more than 52 BITs.	SA is signatory of 18 BITs and member of the Southern African Customs Union (SACU), together with Botswana, Lesotho, Namibia and Swaziland.

Table A-23

INCENTIVES AND PROPERTY RIGHTS PROTECTION IN COMPARATIVE COUNTRIES

	CHILE	SOUTH AFRICA
Performance Requirements and Incentives	<p>Local and foreign investors are alike regarding incentives and programs. Since 2002, there are tax benefits for international companies headquarters which decide to move to Chile. There are not performance requirements, even in project reviews by the FIC. There are not direct subsidies for FDI. There are regional incentives to invest in isolated areas and to the IT sector. CORFO co-finances programs to pre-investment feasibility studies in biotechnology, R&D of new materials, electronics and engineering processes and new production techniques to increase the value added to natural resources.</p>	<p>The Government offers grants up to 15% of the value of the machinery and equipment to foreign investors relocating to SA (up to a maximum of US\$ 430,000). There are also FTZ, grants for training programs, tax allowances on capital expenditures in "strategic" sectors, funds for development costs of infrastructure projects and SME programs. At provincial level, there incentives to encourage investors to relocate industries (low interest rates, reduced cost of land, rebates, etc.). The state-owned Industrial Development Corporation (IDC) provides financial support to target sectors and exporters. The agency Technifin finances marketing of new technology and products. There are requirements for foreign companies involved in a large amount procurement. Companies under control of non-residents (generally, with more of 75% of voting equity) cannot borrow locally without prior approval of the CB.</p>
Protection of Property Rights	<p>Chile is signatory of the WIPO treaties. Intellectual properties rights law and regulations and enforcement seem to be inadequate. Particularly in patent and confidential data protection in the pharmaceutical sector and in copyright piracy. Trademark law consistent with international standards.</p>	<p>With the objective of changing the land distribution pattern inherited from the Apartheid regime, the Government expropriated some large farms compensating their white owners. Patents and trademarks may license locally but payments must be approved by the Government and authorized by the CB.</p>

ANNEX: Doing business in MERCOSUR

The following tables show detailed information on several indicators composing the “Doing Business” index of the World Bank.

Regarding *starting a business*, the number of procedures ranges from 5.7 to 9.5 for the average country considered by region, being the larger figure that belonging to Latin America and the Caribbean region. However, with the exception of Paraguay, the rest of MERCOSUR countries are well above the range, with 11 to 16 procedures. The time to start up a business is about 10 times in Brazil relative to the average of the OECD countries and the double of the regional average. The cost ranges between 56%-11% of the GDP per capita, being the Latin America and the Caribbean average around 36% of the national income per inhabitant.

Dealing with construction permits places Argentina in the first decile of the worst ranked countries and Uruguay, in the third decile. In both countries, the quantity of procedures is much

Table A-24
Starting a Business

Region or Economy	Procedures (number)	Time (days)	Cost (% of income per capita)	Min. capital (% of income per capita)
East Asia & Pacific	8.1	41.0	25.8	21.3
Eastern Europe & Central Asia	6.7	17.4	8.3	21.5
Latin America & Caribbean	9.5	61.7	36.6	2.9
Middle East & North Africa	7.9	20.7	34.1	129.7
OECD	5.7	13.0	4.7	15.5
South Asia	7.3	28.1	27	26.9
Sub-Saharan Africa	9.4	45.6	99.7	144.7
Argentina	15.0	27.0	11.0	2.9
Brazil	16.0	120.0	6.9	0
Paraguay	7.0	35.0	56.7	0
Uruguay	11.0	65.0	40.0	0
<i>Chile</i>	<i>9.0</i>	<i>27.0</i>	<i>6.9</i>	<i>0</i>
<i>South Africa</i>	<i>6.0</i>	<i>22.0</i>	<i>5.9</i>	<i>0</i>

larger than the regional or the OECD averages. This helps to explain the low position in the ranking.

Table A-25
Dealing with Construction Permits

Region or Economy	Procedures (number)	Time (days)	Cost (% of income per capita)
East Asia & Pacific	18.6	168.6	139.6
Eastern Europe & Central Asia	22.6	264.2	536.9
Latin America & Caribbean	16.7	225	210.8
Middle East & North Africa	18.9	159.3	358.4
OECD	15.1	157	56.1
South Asia	18.4	241	2,310.60
Sub-Saharan Africa	17.3	260.5	1,955.60
Argentina	28	338	145.1
Brazil	18	411	50.6
Paraguay	13	291	298.3
Uruguay	30	234	87.1
<i>Chile</i>	18	155	97.8
<i>South Africa</i>	17	174	24.5

To employ a person in Paraguay increases substantially the investment costs due to difficulties to fire redundant workers and to the level of the severance payments (equivalent to 99 weekly salaries). Argentina presents a similar situation.

Table A-26
Employing Workers

Region or Economy	Difficulty of hiring index (0-100)	Rigidity of hours index (0-100)	Difficulty of redundancy index (0-100)	Rigidity of employment index (0-100)	Redundancy costs (weeks of salary)
East Asia & Pacific	19.2	8.6	19.6	15.8	42.4
East. Europe & C. Asia	31.9	29.9	25.9	29.2	27.8
Latin America & C. M East & North Africa	34.4	21.3	24.1	26.6	53
OECD	21.3	22.1	30	24.5	53.4
South Asia	26.5	30.1	22.6	26.4	26.6
Sub-Saharan Africa	27.8	10	41.3	26.3	75.8
Argentina	37.3	29.3	39.8	35.5	67.6
Brazil	44	20	0	21	95
Uruguay	78	60	0	46	46
Paraguay	33	20	0	18	31
<i>Chile</i>	56	53	60	56	99
<i>South Africa</i>	33	0	20	18	52
	56	20	30	35	24

Registering a property may be problematic in Uruguay. In fact, it can take 9 steps to complete the procedure (the average of LAC is 6.8), it can last more than 2 months and cost around 7% of the property value. In Argentina costs are similar but it takes shorter and a less number of steps.

Table A-27
Registering Property

Region or Economy	Procedures (number)	Time (days)	Cost (% of property value)
East Asia & Pacific	5	97.5	3.9
Eastern Europe & Central Asia	5.7	59.7	2.2
Latin America & Caribbean	6.8	70.4	5.9
Middle East & North Africa	6.1	36.1	5.7
OECD	4.7	25	4.6
South Asia	6.3	105.9	5.6
Sub-Saharan Africa	6.7	80.7	9.9
Argentina	6	52	7.0
Brazil	14	42	2.7
Uruguay	9	66	7.1
Paraguay	6	46	3.5
<i>Chile</i>	6	31	1.3
<i>South Africa</i>	6	24	8.7

In Uruguay, there are 53 payments a year related to taxes. In Paraguay this number is not much better, 35 times a year. The time it takes to prepare, file and pay the corporate income tax, the value added tax and social security contributions reach to 2,600 hours a year in Brazil, several times more than in the rest of the MERCOSUR member-countries. Argentina is the country with the higher tax rate.

Table A-28
Paying Taxes

Region or Economy	Payments (number per year)	Time (hours per year)
East Asia & Pacific	24.6	227.2
E. Europe & Central Asia	46.3	336.3
Latin America & C.	33.2	385.2
M.East & North Africa	22.9	204.2
OECD	12.8	194.1
South Asia	31.3	284.5
Sub-Saharan Africa	37.7	306
Argentina	9	453
Brazil	10	2,600
Paraguay	35	328
Uruguay	53	336
<i>Chile</i>	10	316
<i>South Africa</i>	9	200

An exporter spends 33 days to complete an operation if located in Paraguay and 19 days if sells from Uruguay. Also importing to these countries takes one month and 22 days, respectively.

Table A-29
Trading Across Borders

Region or economy	Documents to export (number)	Time to export (days)	Cost to export (US\$ per container)	Documents to import (number)	Time to import (days)	Cost to import (US\$ per container)
East Asia & Pacific	6.7	23.1	909.3	7.1	24.3	952.8
E. Europe & Central Asia	6.5	26.8	1,581.80	7.8	28.4	1,773.50
Latin America & C.	6.8	18.6	1,243.60	7.3	20.9	1,481.00
Middle East & North Africa	6.4	22.5	1,034.80	7.4	25.9	1,221.70
OECD	4.3	10.5	1,089.70	4.9	11	1,145.90
South Asia	8.5	32.4	1,364.10	9	32.2	1,509.10
Sub-Saharan Africa	7.8	33.6	1,941.80	8.8	39.4	2,365.40
Argentina	9	13	1,480	7	16	1,810
Brazil	8	12	1,540	7	16	1,440
Paraguay	8	33	1,440	10	33	1,750
Uruguay	10	19	1,100	10	22	1,330
<i>Chile</i>	6	21	745	7	21	795
<i>South Africa</i>	8	30	1,531	9	35	1,807

Closing a business (going bankrupt) can take 4 years in Brazil and Paraguay. The recovery rate - cents per dollar recouped by creditors through the bankruptcy, insolvency or debt enforcement proceedings- reaches to 17 cents in Brazil and 20 cents in Paraguay.

Table A-30
Closing a Business

Region or Economy	Recovery rate (cents per dollar)	Time (years)	Cost (% of estate)
East Asia & Pacific	28.4	2.7	23.2
Eastern Europe & Central Asia	31.6	2.9	13.5
Latin America & Caribbean	26.8	3.3	15.9
Middle East & North Africa	29.9	3.5	14.1
OECD	68.6	1.7	8.4
South Asia	20.4	4.5	6.5
Sub-Saharan Africa	17	3.4	20.1
Argentina	29.8	2.8	12
Brazil	17.1	4.0	12
Paraguay	20.7	3.9	9
Uruguay	43	2.1	7
<i>Chile</i>	21.3	4.5	15
<i>South Africa</i>	32.2	2	18

ANNEX Questionnaire

Presentation: In our project we are studying the business environment to attract FDI to the agroindustrial sector in MERCOSUR member-countries, we are interested in each particular country and in the perspectives to improve MERCOSUR as a whole. Our final aim is to provide the authorities of the region with an inventory of obstacles to investment as perceived by the businessmen and bankers in the field and with a set of sounding policies to improve the business environment in MERCOSUR as a whole.

Questions: The main questions targeted for the interviews are the following:

When considering an agro-industrial project in the country of the interview which are the main obstacles you have to face? Do they refer to:

- the availability of skilled workers and the labor cost, the possibility of labor conflicts, others;
- the regulations on capital flows, the availability and cost of domestic credit, regulations on the capital market, the corporate governance rules;
- the possibility of changes in taxes or labor and trade regulations during the development of your project, the availability of currency and exchange rate controls

When considering the key factors that attracted first your attention to analyse new projects in the country, which are the ones that you consider more important (the size of the market, the growth prospects, the presence of your own competitors in that market, the possibility of exporting to other MERCOSUR countries or to the rest of the world?

Which do you think will be the main contribution of your company or project to the agroindustrial chain of the country of the interview? And to MERCOSUR as a whole?