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Trading Away Industrialization?

CONTEXT AND PROSPECTS OF THE EU-MERCOSUR AGREEMENT

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EXECUTIVE SUMMARY

The EU-MERCOSUR agreement may contribute to wage stagnation, higher inequality, premature deindustrialization, higher dependence on external demand and other adverse outcomes. Existing projections rule out these outcomes because they overlook critical changes that are under way in both the EU and MERCOSUR. In contrast, they predict small or negligible GDP gains for all countries.

As other free-trade agreements, the EU-MERCOSUR agreement may lead to some job creation, but it may also lock many countries in a condition of technological and industrial subordination, with adverse consequences in terms of inequality, growth and development. Considering the participating countries' economic structures and their evolution, the agreement may well lead to the expansion of low-productivity, low-wage sectors at the expense of more dynamic sectors, reinforcing the drivers of inequality and economic stagnation.

Simple analysis of publicly available data helps capture the critical insight that is missing in model simulations, showing that ongoing changes in the sectoral composition of the economy are cause for concern both in the EU and in MERCOSUR.

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Distinguishing between "dynamic" and "stagnant" sectors of the economy in a sample of EU and MERCOSUR countries – Argentina, Brazil, Czech Republic, France, Italy, Germany, Poland and Turkey – we obtain three main results:

1. All countries in our sample have recently experienced economic polarization becoming more vulnerable to the risks of trade liberalization;
2. Existing projections point to small GDP gains from the agreement while polarization and other adverse outcomes are assumed away; and,
3. Based on these projections, the agreement is likely to push most countries further away from sustainable growth and development.

1. EU and MERCOSUR countries experiencing economic polarization are more vulnerable to the risks of trade liberalization

All countries in our sample have recently experienced a form of economic polarization whereby employment is increasingly concentrated in stagnant sectors and value added is increasingly concentrated in dynamic sectors (Table 1).

From the data, three categories emerge: economies that were recently still industrializing (Czech Republic and Poland), advanced economies that were recently de-industrializing (including Germany, France and Italy), and developing economies that were recently de-industrializing (Argentina, Brazil, and Turkey). All countries exhibit a growing imbalance between high-productivity-high-wage-growth sectors, which we refer to as "dynamic" sectors, and low-productivity-low-wage-growth sectors, which we refer to as "stagnant". In all countries employment moved from dynamic to stagnant sectors while value added generation moved in the opposite direction, away from stagnant sectors. This structural polarization, or "reverse duality", is the main cause of the downward trend of productivity growth observed in all countries. It is also the cause of the increase in inequality observed in most countries.

Table 1: Size of the Stagnant Economy

	Size of the Stagnant Economy, 2014				Real Wage Growth	Productivity Growth	Labor Share	
	Employment Share	'00-'14	Value Added Share	'00-'14	annual avg	annual avg	2014	'00-'14
	%	ppts	%	ppts	%	%	%	ppts
Argentina	65.6	7.3	56.3	-0.3		-0.16		
Brazil	54.5	7.0	43.6	-7.1	2.2	1.9	55.0	5.0
Czech Rep.	34.8	3.4	23.3	-8.9	2.3	2.2	51.3	2.5
France	37.9	2.8	31.3	-3.6	1.4	1.0	65.0	3.9
Germany	55.8	3.5	51.5	-8.1	0.4	0.5	62.0	-2.0
Italy	55.3	5.5	62.7	-1.3	0.2	-0.3	58.7	3.3
Poland	43.0	4.0	28.8	-9.3	1.6	2.5	49.8	-6.0
Turkey	52.4	7.2	46.9	-11.5	0.8	3	37.9	-4.1

Note: For Argentina end of period data refer to 2018 and labor share data come from national accounts.

2. Existing projections on the EU-MERCOSUR FTA point to small GDP gains, while economic polarization and other adverse outcomes are assumed away

Existing projections of the effects of the agreement, based on model simulations, point to small or negligible gains in terms of GDP (Table 2). These gains do not usher in a period of faster growth and, in fact, are a short-lived occurrence. Meanwhile, the studies assume away any adverse effects, including on employment, inequality, industrialization and development. In particular, simulations results are driven by three problematic assumptions: full employment, constant income inequality and fixed productivity growth.

Table 2: Growth Gains from EU-MERCOSUR Agreement (Percent Change Compared to Baseline GDP)

	LSE (2020)	EC (2007)	Diao et al. (2003)
Argentina	0.7	0.5	4.35
Brazil	0.3	1.5	2.86
Paraguay	0.1	10	n.a.
Uruguay	0.4	2.1	1.9
EU	0.1	0.1	0.3

Note: Figures referring to LSE (2020) reflect the optimistic scenario.

Different sectoral impacts are also evident in the employment projections with the latest study suggesting deindustrialization in MERCOSUR and negligible employment changes in the EU. But these effects are greatly contained by the assumptions of full employment and constant inequality.

3. The EU-MERCOSUR FTA is not a route to sustainable growth and development

In many countries, existing projections point to output increases in stagnant rather than dynamic sectors (Table 3). But for most countries, taking a "sustainable" growth path requires improving productivity and reducing inequalities. This means increasing the size of high-productivity-high-wage "dynamic" sectors. For developing countries, it also means continuing to industrialize (increasing their manufacturing share both in value added and employment) until they can compete in higher value-added market segments.

Expansion of multiple dynamic sectors is critical to generate sufficient domestic demand for dynamic sector output so that surplus labor created by the process of productivity growth is absorbed by dynamic, rather than stagnant, sectors. Expansion of dynamic sectors means increasing labor productivity and output and more productive, better paying jobs. Free trade agreements play a critical role in this process by promoting specialization in some sectors based on countries' existing productive structures. Technological and structural features play an important role in determining who wins and who loses in the long term. Countries that have not advanced in high-productivity manufacturing and related sectors tend to lose out. Technologically advanced (developed) countries tend to win and consolidate their technological advantage.

High-productivity sectors in EU countries may benefit in principle from access to MERCOSUR markets. But the adverse structural transformation that the agreement is likely to accelerate in these countries will undermine the growth of their domestic demand, including for imports. While the export boost is projected to be marginal and short-lived, high-end economic output in the EU is

Table 3: Projected Output Gains of EU-MERCOSUR Agreement in Stagnant and Dynamic Sectors

	Sectors	EU28 (sectoral characterization approximated based on our results)		Average	Brazil		Average	Argentina		Average
AGRI-FOOD	Cereals	-0.5	Stagnant		2.4	Dynamic		0.8	Dynamic	
	Rice	-0.5	Stagnant		1.7	Dynamic		0.8	Dynamic	
	Vegetables, fruit, nuts	-0.5	Stagnant		2.2	Dynamic		3.1	Dynamic	
	Oil seeds, vegetable oils	-0.5	Stagnant		3.2	Dynamic		1.9	Dynamic	
	Sugar	-1.0	Stagnant		2.5	Dynamic		1.2	Dynamic	
	Plant and animal fibers	-0.4	Stagnant	**-0.47**	1.3	Dynamic	**1.91**	0.5	Dynamic	**1.27**
	Processed foods, fish	-0.3	Stagnant		1.7	Dynamic		1.5	Dynamic	
	Beef and sheep meat	-1.2	Stagnant		2	Dynamic		2.4	Dynamic	
	Poultry meat, pork	-0.3	Stagnant		3.7	Dynamic		0.5	Dynamic	
	Other animal products	-0.3	Stagnant		2.2	Dynamic		1.5	Dynamic	
	Beverages and tobacco	0.0	Stagnant		0.2	Dynamic		0.4	Dynamic	
	Dairy products	-0.1	Stagnant		-0.2	Dynamic		0.6	Dynamic	
MINING	Wood and paper	0.0	Stagnant		0.6	Dynamic		0.1	Stagnant	
	Coal	0.0	Stagnant		0.2	Dynamic		0.2	Stagnant	
	Oil	0.0	Stagnant	**-0.12**	0.1	Dynamic	**0.18**	0.1	Stagnant	**0.62**
	Gas	-0.6	Stagnant		-0.1	Dynamic		2.6	Stagnant	
	Minerals	0.0	Stagnant		0.1	Dynamic		0.1	Stagnant	
MANUFACTURING	Textiles, apparel, leather	-0.1	Dynamic		0.9	Stagnant		0.9	Dynamic	
	Chemicals, rubber, plastic	0.2	Dynamic		0.2	Stagnant		-0.2	Dynamic	
	Petroleum, coal products	0.1	Dynamic	**0.10**	0.1	Dynamic	**-0.12**	0.4	Dynamic	**0.12**
	Metal products	0.2	Dynamic		-2.5	Dynamic		-1.3	Dynamic	
	Non-metallic minerals	0.2	Dynamic		0.7	Stagnant		0.8	Dynamic	
	Vehicles, transport equipment	0.6	Dynamic		-1.8	Stagnant		-3.2	Stagnant	
	Machinery	0.5	Dynamic	**0.20**	-5.1	Stagnant	**-1.57**	-2.9	Stagnant	**-1.33**
	Electronic equipment	-0.4	Dynamic		2.2	Stagnant		2.7	Stagnant	
SERVICES	Electricity	0.1	Stagnant		0.2	Dynamic		0	Dynamic	
	Utilities	0.4	Stagnant		0.7	Stagnant		1.5	Dynamic	
	Transport	0.0	Dynamic		0.4	Stagnant		0.8	Dynamic	
	Telecoms, business services	0.0	Dynamic	**0.07**	0.7	Dynamic	**0.45**	1	Stagnant	**0.77**
	Financial services	-0.1	Dynamic		0.4	Dynamic		0.7	Stagnant	
	Other services	0.0	Stagnant		0.3	Stagnant		0.6	Stagnant	

Note: CGE Modeling results (Table 9) from SIA Report (2020). All numbers are in % change relative to their baseline. Sectoral characterization is made based on authors' evaluations.

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unlikely to expand substantially while stronger cost competition in more stagnant sectors is likely to undermine their wage and productivity growth, ultimately compromising economy-wide demand expansion and leading to a deterioration of income distribution. The current trend toward widening economic duality in all countries of our sample, coupled with the historical retreat of public investment and industrial policy, is a conduit to adverse structural change and an accelerator of the global race to the bottom in labor costs.

Furthermore, the agreement's environmental outcomes may affect economic performance negatively. For example, projected expansion of agri-food and mining output may lead to changes in land-use, to deforestation and higher carbon emissions in Brazil and Argentina[2], with negative impacts on inequality. While an analysis of these impacts is beyond the scope of this paper, the analysis shows that appropriate industrial and income policies – ideally reflected in a binding chapter on sustainability[3] – are necessary to ensure that the agreement is sustainable economically, socially and environmentally.

In the context described in the paper, more trade liberalization may well be a step toward less productive, more unequal and more vulnerable economies. These risks may or may not materialize but they are assumed away in existing assessments of the agreements, which are not, therefore, an informative basis for policymaking.

[2] According to Abman & Lundberg (2020), deforestation tends to increase within a few years after the enactment of the free trade agreements.

[3] See Harrison and Paulini (2020), Alguiar et.al. (2020, Chapter 3) for more details.