Economic Integration in the Americas

Edited by
Joseph A. McKinney and H. Stephen Gardner

Routledge Studies in the Modern World Economy

Economic Integration in the Americas

This book provides a comprehensive account of the subregional integration agreements in the Americas. These initiatives have become increasingly important given the demise of the FTAA and the ongoing stalemate in multilateral trade negotiations. The book covers the subject from three distinct levels of analysis (strategy, implementation and outcomes). This informative volume is of benefit for all those interested in the current state of trade negotiations and regional integration, practitioners and non-practitioners alike.

(Esteban Pérez Caldentey, Economic Commission For Latin America and the Caribbean)

This new book brings together contributions from recognized experts in trade policy, discussing and evaluating economic integration in the Western Hemisphere, the alternative trade strategies being pursued in this area, and Latin American relationships with United States and Canada.

These essays provide progress reports concerning the different regional and subregional groupings that have developed within the hemisphere and discuss the inter-relationships of western hemispheric trading arrangement with the multilateral trading system. The difficulties encountered in hemispheric trade negotiations and the implications for the countries involved are also considered.

This book will be of great interest to students and researchers engaged with international trade and economic policy, as well as policy specialists in business organizations and government.

Joseph A. McKinney is Ben H. Williams Professor in International Economics at Baylor University. **H. Stephen Gardner** is Professor of Economics and Director of the McBride Center for International Business at Baylor University, Texas.

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Preface

The vision of a Western Hemisphere free of trade impediments has existed for more than a century. At the Washington Conference of American states held in 1889–1890, US Secretary of State James G. Blaine proposed a hemispheric free trade agreement. This proposal was unfortunately rejected by Latin America representatives (Weintraub, 1994). Over the next seventy years each country followed its own inclinations with regard to international trade policies. Latin American countries bore the full brunt of United States protectionism during the inter-war period with the imposition of the Smoot–Hawley tariff. After World War II, when the United States led in the establishment of the world trade regime and worked for multilateral tariff reductions, Latin American countries adopted import-substituting industrialization policies. These policies encouraged development of domestic industries by protecting them in various ways from foreign competition. As a result, Latin American economies isolated themselves to varying degrees from the world economy.

A number of regional economic integration arrangements sprang up in Latin America in the 1960s in emulation of the newly developing European Economic Community. Policy-makers had come to recognize that for many industries the domestic markets of Latin American countries were too small to allow for realization of economies of scale. A major motive for the regional trading arrangements of the 1960s was to move the process of import-substituting industrialization from the national to the regional level. Consequently, the free trade areas and common market arrangements formed during this period maintained or imposed stiff trade barriers on products from outside countries. Furthermore, the economic integration arrangements during this time were rife with exceptions and often depended on negotiated reductions by sector rather than by across the board reductions in trade restrictions. Consequently, not much was accomplished in the way of true economic integration during this period.

The economic policy environment changed considerably in Latin America between the 1960s and the 1990s. Both the foreign debt crisis of the 1980s and the demonstration effect of outward-looking Asian countries that were experiencing rapid economic growth caused a shift away from import-substitution policies that had come to be regarded as counterproductive. Consequently, a number of Latin American countries engaged in significant economic reform

programs during the 1980s that involved unilateral tariff reductions, privatization of industries, and general deregulation of economic activities.

Mexico's request in 1990 to enter into a North American free trade agreement with the United States and Canada triggered a new round of regional economic integration activity throughout the Western Hemisphere. President George H.W. Bush launched his Enterprise for the Americas Initiative in 1990, proposing free trade throughout the Western Hemisphere by the year 2000. In 1991 the MERCOSUR (southern common market) was established by Argentina, Brazil, Paraguay, and Uruguay. The Central American Common Market, which had previously fallen apart, began to put its pieces together again in 1991. The Andean Common Market was revived in 1990. The Caribbean Community countries began lowering their common external tariff in 1993.

Given these developments in the early 1990s, prospects for economic integration in the Americas seemed exceedingly bright. Latin American countries had established a policy climate much more conducive to regional economic integration. With the end of the Cold War, for the first time in many years the United States was seriously focusing attention on Latin America. At a Summit of the Americas held in Miami in December 1994, thirty-four of the hemisphere's thirty-five countries agreed to establish a Free Trade Area for the Americas by 1 January 2005. Much momentum and enthusiasm for the process existed. Formal integration of the economies of the Western Hemisphere, which only a few years earlier would have been regarded as totally unrealistic, seemed almost overnight to be a real possibility.

Sadly, it was not to be. Hardly had the ink dried on the Miami Summit Declaration before Mexico experienced a severe financial crisis. President Bill Clinton used extraordinary procedures to put together a funding package that enabled Mexico to recover rapidly from its financial crisis, but much damage had been done. The stereotype of Latin American economies as unstable had been reinforced. Enthusiasm for further economic linkages between the United States and Latin America waned considerably. Further complicating matters was the deadlock within the United States Congress between Republicans and Democrats over whether or not labor and environmental provisions should be included in future trade agreements. As a result of this deadlock, President Clinton was denied renewal of trade promotion authority throughout his terms in office.

Formal negotiations for a Free Trade Area for the Americas did not get underway until April 1998. Under the best of circumstances these would have been challenging negotiations. The thirty-four countries involved were widely disparate in terms of economic size, levels of prosperity, and geopolitical influence. Some of the Latin American countries were greatly deficient in negotiating capacity, and even lacked data concerning their foreign trade and trade practices. The two largest countries in the hemisphere, the United States and Brazil, had largely incompatible agendas for the negotiations. Given these challenges, the momentum lost in the years immediately following the 1994 Miami Summit significantly reduced the prospects for successful negotiations.

The two countries crucially important for moving the FTAA negotiations

forward, Brazil and the United States, failed to exercise leadership in the negotiations. Brazil seemed intent on consolidating a united front in South America in order to increase bargaining leverage with the United States before engaging in serious negotiations. Also, Brazil was particularly interested in access to the US market for its agricultural commodities and changes in US antidumping policies and practices. Both of these issues were extremely difficult ones for the United States. Reduction or elimination of US agricultural subsidies can occur only within the context of an agreement between the United States and the European Union on this issue. As for reform of US antidumping policies, this is highly unlikely so long as members of the US Congress consider them the optimal safety valve for extreme political pressures coming from trade-affected constituents.

For its part, the United States viewed a hemispheric trade agreement as involving much more than market access. Enhanced intellectual property protection and liberalized foreign investment rules were major goals that the United States was intent on attaining, seemingly without offering much in return. The United States failed to appreciate fully the historic potential of the FTAA to affect the geopolitical situation in Latin America. The hemispheric cooperation such an agreement would have brought about would have helped to anchor structural reforms, strengthen fragile democracies, and extend modernization to backward areas of the region.

Frustrated by Brazil's perceived intransigence, the United States attempted to put pressure on Brazil by negotiating bilateral agreements with individual countries, and groups of countries, within the hemisphere. Brazil and its MERCOSUR partners responded by taking in several associate members, by negotiating free trade agreements with external partners such as the European Union, and by linking up with the Andean Common Market to establish the Union of South American Nations.[1] At the same time, leftist governments in the region led by Venezuela moved to organize the Bolivarian Alternative for the Americas with the stated intention of becoming an alternative to the so-called neoliberal Free Trade for the Americas.[2]

To consider the implications of these developments, we organized a conference that was held on the campus of Baylor University on 6–7 October 2005. The conference brought together noted international trade policy experts from throughout the hemisphere to consider the status of economic integration in the Americas and the outlook for future developments concerning it.

This latest conference built upon three previous Baylor University conferences that dealt with hemispheric economic integration issues. In 1989, the Region North America: Canada, United States and Mexico conference considered the prospects for a free trade agreement that would include all three countries of North America, and attempted to assess the ramifications of such a development. In 1992, the year in which the North American Free Trade Agreement was signed, a second conference entitled Implications of a North American Free Trade Region: Multidisciplinary Perspectives gathered experts from the three countries of North America to consider the implications of the trade

agreement from economic, political, legal, social and cultural perspectives. In 1994, when a Free Trade Area for the Americas was being considered, a third conference, entitled Free Trade in the Americas: Issues in Economics, Trade Policy and Law, gathered experts from throughout the Western Hemisphere to discuss hemispheric free trade from several perspectives.

For the most recent conference, noted international trade experts were invited to critically evaluate the new trade strategies being employed in the Americas. We asked them to consider how the different regional and subregional agreements related to each other, and whether they would help or hinder the wider goal of hemispheric free trade. Of particular interest was the question of what the different trade strategies being pursued in the Americas implied for the future of the multilateral trading system. We were privileged to have the outgoing Director General of the World Trade Organization, Dr Supachai Panitchpakdi, to open the conference with his perspective on this issue.

We are grateful to all of the speakers at the conference, many of whom traveled long distances and took time from demanding schedules to participate. Robert Devlin made an excellent presentation at the conference, but the demands of a new job unfortunately prevented him from contributing to the conference volume. Anneke Jessen was not a conference participant, but was commissioned afterward to write a paper on economic integration in the Caribbean in order to give complete coverage of the hemisphere. As is typical of conference volumes, the papers here vary considerably in length and style. However, each contribution is by an expert with much experience in the field and offers a valuable perspective on the issues. At each author's discretion, some, but not all, of the papers have been updated to take account of events between the time of the conference and publication of this volume.

The Free Trade in the Americas conference was organized and funded by the McBride Center for International Business of the Hankamer School of Business at Baylor University, assisted by a generous conference grant from the Embassy of Canada in Washington, DC. We wish to express our deep appreciation to the Embassy of Canada, and particularly to Dr Daniel Abele, Academic Relations Officer. In addition, we are grateful to the Consulate General of Dallas for continued support for our efforts through the years. Dean Terry Maness, who has been consistently and generously supportive of the international activities of the Hankamer School of Business, deserves special thanks.

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Notes

1 Formed on 8 December 2004 as the South American Community of Nations, this fledgling union, whose goal is to unite MERCOSUR and the Andean Community changed its name on 16 April 2007 to the Union of South American Nations.
2 The Bolivarian Alternative for the Americas was organized by Venezuela and Cuba in 2004, with Bolivia joining in 2006 and Nicaragua in 2007.

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Acronyms

ACP	African, Caribbean and Pacific group
ADC	Andean Development Corporation
APC	Australia Productivity Commission
APEC	Asia Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
ATPA	Andean Trade Preference Act
BIMST-EC	Bay of Bengal Initiative for Multisectoral Technical and Economic Cooperation
BMD	ballistic missile defense
CABEI	Central American Bank for Economic Integration
CACM	Central American Common Market
CAFTA	Central America Free Trade Agreement
CAP	common agricultural policy
CARICOM	Caribbean Community
CARICRIS	Caribbean Regional Credit Rating Agency
CBI	Caribbean Basin Initiative
CBTPA	Caribbean Basin Trade Partnership Act
CCJ	Caribbean Court of Justice
CCMS	Caribbean Centre for Monetary Studies
CER	closer economic relations
CET	common external tariff
CGE	computable general equilibrium
CMS	Constant-market-shares
CNN	Cable News Network
COMESA	Common Market of Eastern and Southern Africa
COTED	CARICOM’s Ministerial Council for Trade and Economic Development
CRNM	Caribbean Regional Negotiating Machinery
CROSQ	CARICOM Regional Organization for Standards and Quality
CSME	CARICOM Single Market and Economy
CUSTA	Canada–US Free Trade Agreement
DR-CAFTA	Free Trade Treaty between the Dominican Republic, Central America and the United States

DSM	dispute settlement mechanism
EAI	Enterprise for the Americas Initiative
ECLAC	Economic Commission for Latin America and the Caribbean
EFTA	European Free Trade Association
EPA	economic partnership agreement
EU	European Union
FDI	foreign direct investment
FIE	foreign invested enterprises
FOB	free on board (including product price only, not insurance and freight)
FTA	free trade agreements
FTAA	Free Trade Area of the Americas
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GSP	gross state product
GSTP	Global System of Trade Preferences
GTAP	Global Trade Analysis Project
HS	harmonized system
IBSA	India, Brazil, South Africa
ICSID	International Centre for Settlement of Investment Disputes
ICT	information and communications technology
IDB	Inter-American Development Bank
IIRSA	Integration of Regional Infrastructure in South America
IMF	International Monetary Fund
IMSS	Mexican Social Security Institute
IP	intellectual property
IPR	intellectual property rights
LAC	Latin America and the Caribbean
LDC	less developed countries
MAI	Multilateral Agreement on Investment
MASA	Multilateral Air Services Agreement
MERCOSUR	Southern Common Market
MFN	most-favored-nation
MIA	Multilateral Investment Agreement
MOFA	Majority-Owned Nonbank Foreign Affiliates
MTS	multilateral trading system
NADBank	North American Development Bank
NAFTA	North American Free Trade Agreement
NAMA	non-agricultural market access
NASPP	North American Security and Prosperity Partnership
NGO	non-governmental organization
OECD	Organization for Economic Co-operation and Development
OECS	Organization of Eastern Caribbean States
OEM	original equipment manufacturers

PT	preferential trade
PTA	preferential trade agreements
R&D	research and development
RASOS	Regional Aviation Safety Oversight System
ROO	rules of origin
RTA	regional trade agreements
SACU	South African Customs Union
SGCAN	Secretary General of the Andean Community of Nations
SG-SIC	Secretary General of the Central American Integration System
SMART	United States initiative to strengthen border security
SOE	state-owned enterprise
TFP	total factor productivity
TPA	trade promotion authority
TRIMS	WTO Agreement on Trade Related Investment Measures
UNCTAD	UN Conference on Trade and Development
UNIDO	UN Industrial Development Organization
US-LAC	United States – Latin America and Caribbean
USTR	Office of the United States Trade Representative
VER	"voluntary" export restraints
WTO	World Trade Organization

Part I

Introduction

1 Introduction

Supachai Panitchpakdi

As the new Secretary-General of the United Nations Conference on Trade and Development (UNCTAD), and the former Director General of the World Trade Organization, trade agreements are a subject that interests me greatly. My government experience in Thailand has also shaped my thinking on this important issue, so I am very happy to have been given this opportunity to make some observations on the subject. I will address the important subject of this volume – economic integration in the Americas – but I will also attempt to set it in a broader context of regional and multilateral cooperation.

Persistent difficulties in the current round of WTO negotiations may pose serious challenges for the future of multilateralism and for efforts to make trade an engine of growth and development through multilateral liberalization. In the face of these difficulties, we may expect a further intensification of the regional approach to trade relations, which has become the norm in recent years. The emergence of new regionalism raises many issues as to its economic consequences and its interface with the multilateral trading system (MTS). One of the concerns is its impact on the sustainability of that system, including whether regional integration becomes a building block or stumbling block for multilateralism. This is linked to the incompatibility between regional trading arrangements (RTAs) and the MTS, as the former are an exception to the most-favoured-nation (MFN) principle. Thus, one view has it that the proliferation of RTAs could weaken the MTS and be detrimental to developing countries. Another view has it that RTAs, depending on their nature and content, could actually help reinforce the MTS and provide important benefits for developing countries. The overall effects of RTAs also depends on the choice of partners: agreements among developing countries (South–South RTAs) will differ in several respects from those between developed and developing countries (North–South RTAs), for instance. The jury is still out on this, and the whole issue of regionalism vs multilateralism remains an open question that deserves further analytical work.

This paper addresses the reasons behind the lack of consensus on this issue. I first say a few words on the proliferation of regional groupings or trading arrangements in recent years and the challenges they pose. Then I briefly examine the specific features of South–South and North–South RTAs. Finally, I share my views on the regionalism vs multilateralism debate as a whole.

Rise of a new regionalism

A new regionalism is rapidly sweeping through all regions of the world, dramatically changing the international trading environment. The number of RTAs has increased sharply over the last twenty years – from less than twenty-five in 1985 to 190 by the end of the 1990s. By 2005, some 300 RTAs had been notified to the WTO, and some 200 are currently in force. Virtually all WTO members are parties to at least one RTA, and many have embraced two or more. Recently, new RTAs have been initiated by countries that had traditionally been among the main proponents of the multilateral approach under the GATT, such as Japan, the Republic of Korea, Singapore and other countries in East Asia.

Bilateral free trade agreements (FTAs) between countries belonging to the same broad geographical region have continued to predominate. However, the growing number of newly formed RTAs, and those at various stages of negotiation, is proof that bilateral FTAs between countries belonging to different continents are becoming increasingly common. The inclusion of diverse groups of countries in different regions and at different stages of development has given rise to a variety of typologies of RTAS, including South–South, North–North and North–South agreements.

In this respect, I wish to underscore the important role that the United States is playing by contributing significantly to this trend. The US has recently signed, or is in the process of negotiating, several intra-regional and intercontinental agreements with Jordan, Singapore, Australia, Morocco, Central American countries, and Southern African Customs Union members, to name just a few. Earlier, the US had concluded the NAFTA with Canada and Mexico.

Challenges posed by RTAs

The proliferation of RTAs has prompted popular catchphrases intended to describe the complex process of regionalism: building blocks vs stumbling blocks is probably the best-known, but there is also the “spaghetti bowl” phenomenon. The “hub-and-spoke effect” and the “domino theory” are all attempts to encapsulate in simple terms the various aspects of RTA formation.

Irrespective of such catchphrases, regionalism has continued to raise a number of new challenges. Not only has the number of RTAs increased over time, but so has the complexity of issues surrounding their formation. Integration has now become much deeper, more multifaceted and multisectoral, encompassing a wide range of economic and other political objectives.

Recent RTAs, for example, have involved ever-widening coverage of the agreements, going beyond trade in goods to include trade in services and other trade-related policy areas, such as intellectual property rights, investment, competition policy, and government procurement. In addition, physical integration through joint infrastructure development, technological and scientific cooperation, environment, common competition policies or monetary and financial

integration, social and cultural cooperation, political and security cooperation, and cooperation in other sectors have been pursued to enhance regional economic linkages, stability and solidarity.

The importance of an integrated approach to trade and development in RTAs to ensure development gains is crucial for a complementary approach between these agreements and the multilateral trading system. This was the case with both CAFTA and the extension of the principles of social cohesion and structural funds under the EU agreements. Other examples are the regional infrastructure programmes between Brazil and Peru, Brazil and Venezuela, Brazil and Bolivia, and within MERCOSUR. The newly created Bay of Bengal Initiative for Multisectoral Technical and Economic Cooperation (BIMST-EC) also aims to step up trade, accompanied by regional infrastructure development, in order to enhance connectivity and trade facilitation among the members. Other development features may include reduction of tariff peaks by developed countries; provision of adjustment support, technological support and technical assistance; facilitating mobility of workers; and developing regional trade remedy rules.

It would thus appear that the traditional analysis and understanding of RTAs, based upon trade creation and trade diversion effects, although still valid, might need to be complemented by insights that reflect new developments and their diverse nature. We know now that RTAs can bring further welfare gains under imperfect competition. New endogenous growth theory postulates that regional economic integration can lead to permanent changes in the rate of growth of integrating economies through various transmission channels, such as scale effects and increased diffusion of knowledge or technology.

There is also greater awareness today of the negative effects of barriers – which raise transaction costs and inhibit trade – and of the value of removing them among RTA members. It is also widely believed that geographical proximity and the functional interdependencies and cross-border externalities that it creates, has favourable indications for regional economic growth. Indeed, this has been one of the driving forces, in addition to increasing regional trade, behind the explosion of regional groupings and arrangements in the South in recent years.

All of these challenges are becoming strategically important. This makes it even more crucial to ensure that RTAs are conducive to strengthening the MTS by minimizing their possible negative effects, while allowing developing countries to maximize their trade gains in the different layers of integration. One key question then emerges: how well-equipped are the different types of RTAs for fostering economic, human and social development, and poverty alleviation?

South–South RTAs

South–South RTAs are seen, especially in Africa, as a development strategy for bringing about greater economies of scale and integration within the various subregions and the continent to act as a springboard for competitive participation in global trade. For example, COMESA has formed an FTA and is moving

towards a customs union. This wider development objective is also captured in ASEAN, where members recently agreed to create an ASEAN economic community by 2020 to facilitate the freer flow of goods, services, capital and people. The same goal has also been voiced by the Andean Community and CARICOM.

South–South trade has been expanding more rapidly than world trade and thus exhibits great potential for further growth. Asia accounts for the largest share of South–South trade. This is particularly beneficial, as the products traded are high value-added and technology-intensive goods. Such trade is stronger at the regional level, but the potential is great at the inter-regional level as well, including through the Global System of Trade Preferences among Developing Countries (GSTP).

A key challenge for the South–South RTAs is the effective implementation of the liberalization programmes stipulated in the constituent treaties. Experience shows that the degree of implementation of the stated objectives of the RTAs has been greater for the less sophisticated/traditional agreements focusing on trade in goods than for those agreements with wider coverage of trade-related issues and which seek "deeper" integration, such as investment, competition policy and government procurement. The latter type of agreement tends to lag behind the planned timeframe.

So far the widening, deepening and consolidation of regional integration processes within South–South RTAs have contributed to increase intra-regional trade, although this performance varies across groupings. ASEAN and MERCOSUR have attained a relatively high level of intra-regional trade – in both cases well over 20 per cent of their total trade in 2001. However, this figure is low when compared to some North–North RTAs, as the intra-group exports account for 61 per cent of EU exports and 55 per cent of NAFTA exports. A number of other South–South groupings have also performed notably, including the Central American Common Market (15.0 per cent), Union économique et monétaire de l'Afrique de l'Ouest (13.5 per cent), CARICOM (13.4 per cent) and Southern African Development Community (10.9 per cent). At the other extreme, the share of intra-regional trade in total trade for some African groupings, such as the Communauté économique et monétaire de l'Afrique Centrale, has been just above 1 per cent.

The upward trend in trade under South–South RTAs is consistent with the burgeoning trade among developing countries in general. Currently, about 40 per cent of developing countries' merchandise exports are to other developing countries, growing substantially from a share of 27 per cent in 1980. This is not limited only to intra-regional trade, since inter-regional trade among developing countries is also increasing substantially. Between 1999 and 2002, for example, trade between India and Brazil increased fivefold, from an initial level of $200 million. The GSTP is an important instrument available to developing countries to further promote South–South trade.

North–South RTAs

Another salient feature of the new regionalism is the emergence of North–South RTAs bringing new challenges and opportunities for participating developing countries. These RTAs are likely to be trade-creating because of existing complementarities. The motivations of developed countries for engaging in North–South RTAs arise from North–North relations and “competitive regionalism”.

North–South RTAs could have positive or negative effects on developing countries, depending on a number of factors, including the architecture and structure of these arrangements, the level of existing protection, and the composition and design of rules. Developing countries are increasingly participating in RTAs, with developed countries motivated by the possibility of turning unilateral trade preferences into contractual rights for better market access and entry conditions, expectations of increasing FDI flows and technology, and various strategic reasons, such as political considerations. RTAs also serve as laboratories for liberalization, harmonization of rules and upgrading of the regulatory environment, and raising a country’s trade and investment profile.

On the other hand, one needs to be aware of some limiting factors, such as reduced negotiating capacity and administrative complexity on the part of developing countries. Improved market entry conditions, including simplified rules of origin, mutual recognition of standards and testing results, and trade facilitation measures, should be particularly beneficial to developing countries that are parties to North–South RTAs.

There is a need for North–South agreements to incorporate elements of asymmetry in the form of special and differential treatment in commitments and disciplines, including the level of tariff dismantling, transition period or rules on safeguards and trade remedies, such as de minimis level. Countries have to identify national objectives to pursue in different levels of integration, and to approach negotiations in a coherent and strategic manner. A clear understanding of the impact of agreements and rules being negotiated and sectors covered is essential.

Regionalism vs multilateralism

As I mentioned earlier, apart from the development challenges posed to RTA members, regionalism also raises a systemic challenge to an effective multilateral trading system. A continued concern as regards RTAs is their compatibility with the relevant WTO rules and disciplines, including GATT Article XXIV, which primarily applies to RTAs of the North–North and North–South types. For the latter type of RTAs, there are important development implications arising mainly from the issues of reciprocity and special and differential treatment. Not much progress has been made so far in following up on the Doha work programme in terms of clarifying and improving disciplines and procedures under the existing WTO provisions applying to RTAs, taking into account developmental aspects of these agreements.

There is also a concern that regionalism could be used as a means to expand the trade agenda beyond what is currently possible in the MTS. For example, such issues as intellectual property rights, investment, competition, environment, labour and government procurement could lead to WTO-plus obligations under RTAs. These issues are being taken up within regional integration groupings of developing countries, but raise certain difficulties when approached in the North–South context, especially because of the asymmetries between developing and developed countries on different fronts.

Some see the rapid proliferation of RTAs as a manifestation of frustrations with slow progress in trade liberalization at the multilateral level, including insufficient progress in the Doha work programme to date. While there might be some truth in this, the solution to the problem does not lie in the exit option. Rather, it is the multilateral route that offers the best solution to the liberalization and promotion of trade. One could hardly imagine another avenue for tackling the nettlesome issues of agriculture trade reform and liberalization, such as domestic support and export subsidies. In non-agricultural market access (NAMA), apart from addressing issues of tariff bias, escalation and peaks, the multilateral system provides an opportunity to deal with non-tariff barriers and market entry barriers that are emerging as the main obstacle to effective market access. In services, the WTO offers multilaterally secure and predictable rules, enhanced market access in services sectors and modes of interest to developing countries, as well as possibilities for attracting new investments in infrastructure. Moreover, the modalities on trade facilitation provide a unique model that integrates trade commitments with the provision of investment and trade-related technical assistance and can thus reinforce developing-country backward and forward linkages in the trade facilitation chain. The WTO also has probably the most effective dispute settlement mechanism in place today. Even members of well-established RTAs, such as NAFTA, still resort to that mechanism. For all these issues, no single existing regional or bilateral trade agreement, or any combination thereof, can deliver the same benefits as a well-functioning and development-oriented multilateral trading system.

This underlines the primacy of the multilateral route. That is not to say that RTAs are not desirable. Quite the contrary: as I said earlier, they can offer many important benefits to their participants. All I am saying is that the RTAs, whether in the Americas or elsewhere, must complement the multilateral trading system in order for global welfare from trade to be maximized.

We at UNCTAD have been helping developing countries to deal with the interface between multilateralism and regionalism, and the interplay among RTAs, by strengthening developing countries' trade policy capacity at the regional level, including such aspects as investment, regional institution-building, standard-setting and business regulation. We will continue to facilitate the exchange of experiences, best practices and lessons learned among RTAs; to promote networking and information-sharing among RTAs; to help consensus-building and international cooperation in addressing the development dimension of RTAs and the interface with the MTS, and to undertake a development

impact assessment of RTAs. The overarching objective of our effort is to assist developing countries to effectively meet the challenge of using new regionalism as an effective instrument of developing in a manner complementary to the MTS. Our hope is that, as economic integration progresses in the Americas, care will be taken to ensure that it is complementary in every way to the MTS. Both the region and the world economic system will benefit if it is.

Part II

New trade strategies in the Americas

2 The past twenty years of trade policy

What have we learned so far and what are the lessons for Latin America?

Michael Hart

This is my fourth trip to Baylor University over a period of fifteen years.[1]

Each of these conferences has given me an opportunity to look back, reflect, and consider the extent to which we have been able to make progress, directly in removing barriers to international exchange and, indirectly, promoting economic welfare and prosperity. At this conference, I would like to look back at the past twenty years of trade-policy making, consider what we have learned, and see what those lessons mean for Latin America in devising a trade policy strategy for the immediate future.

In doing so, I must admit that I have become more pessimistic than I was a few years ago. I am at heart an optimist, and I remain optimistic about the future. The progress we have made over the past twenty years will not be easily undone and the further steps we need to take will eventually be taken, but the immediate prospect is not encouraging. The US Congress is going through one of its periodic ugly periods of isolationism and protectionism, and the results are not pretty. Too many American interests, however, are at stake, and this ugly mood will, hopefully, not last long. Nevertheless, it does have important immediate implications for the choices available to countries in Latin America. I will return to this theme later. First, some thoughts about what we have learned.

Lessons from Canada's past

The year 2005 is a good year to look back, particularly for a Canadian. It marks the twentieth anniversary of Canada's decision to say goodbye to more than a century of cautious pragmatism and to put trade policy to work for the broader benefit of all Canadians. We did that by adding to the incrementalism of multilateral negotiations at the GATT the shock of a bilaterally negotiated free trade agreement with the United States. It was a bold – and uncharacteristic – decision and it remains a work in progress, but the results to date have been encouraging. As Canadian economist Daniel Trefler recently concluded, "The FTA was a boon to Canadian productivity,"[2] and as economists all agree, productivity is the key to economic growth and prosperity.

More generally, and viewed from a longer perspective, Canada's approach to trade-policy making has been incremental, pragmatic, and cautious. More could certainly have been done, or done more boldly, but radical departures have, in the view of Canada's trade-policy practitioners, been neither warranted nor likely to succeed. They exhibited a deep appreciation of the basic realities within which Canadian Government policies operate, including the capability and interest of Canadian firms. In Canada, trade and investment are primarily private sector activities. Governments can facilitate or frustrate these activities, but ultimately they do not trade or invest. Those areas in which governments have engaged directly in economic activity – such as crown corporations – have not provided much comfort to those who believe that government can do better than the private sector.

The relatively small Canadian market imposed a second limitation. Without access to foreign markets, it is unlikely that much Canadian industrial production can attain the competitive scale required to finance innovation and other desirable features. Additionally, both business leaders and experienced trade officials have developed a clear understanding of the extent to which foreign markets offer real rather than potential opportunities. In the case of Japan, for example, Canadian exporters have long faced some formidable barriers involving not only market access, but also costs, consumer interests and preferences, and institutional barriers. Even large, well-financed US and EC firms, backed up by the muscle of their much bigger governments, have found the Japanese market tough sledding in areas other than those for which there are no Japanese suppliers. European and developing country markets offer their own difficulties. Over time, Canadian firms might find niches in these markets, but only if they earn enough from Canadian and US markets to finance the effort.

Within these realities, Canadian officials used the policy instruments at their disposal to encourage trade and industrial patterns that provided Canada with growing prosperity. The desired pace of adjustment, however, was dependent on both external and domestic factors. Externally, Canada's major trading partners, particularly the United States, had to open up their markets to Canadian suppliers and accept the discipline of international rules to underwrite this market access. Domestically, governments, firms, and workers had to accept increasing levels of foreign competition and to make constant efforts to upgrade and adjust domestic production. The mutually reinforcing impact of these external and domestic dimensions has been key to the incremental nature of this strategy.

While incremental, the results were impressive. Slowly but steadily, Canada opened its economy to greater competition and became an increasingly adroit practitioner of good trade policy. The Canada–US FTA was a major departure that accelerated the pace of adjustment and adaptation, but would have been much more difficult without the base of solid experience over the previous fifty years of trade negotiations. It may have been a leap of faith, but not a leap in the dark. While there remain exceptions and challenges, the default position for Canada is now clearly free trade and open markets.

Forty years ago, Canada and the United States traded cars and parts across

the border. Today, in the words of business economist Stephen Blank, "we no longer sell cars to each other; we now build them together."[3] Canada and the United States have succeeded in creating a much more integrated North American economy on the basis of rules negotiated bilaterally and multilaterally, and the past twenty years have been among the most critical in transforming economic exchange from cross-border trade to integrated production. The result has been a major re-orientation of the Canadian economy from its traditional east–west lines to more geographically and economically rational north–south lines. Its impact has been to strengthen the Canadian economy and add to the prosperity of all Canadians.

Latin America's more recent experience

What Canada has experienced over the past seventy years has been echoed, sometimes faintly and much less confidently, in much of Latin America over the past twenty. As Indian economist Surjit Bhalla has pointed out, "it does not matter what index is chosen for poor countries: income growth, consumption growth, inequality change, health standards, educational attainment, or poverty decline. The past 20 years were a golden period for poor people."[4] That golden period was most apparent in China, India, and parts of Latin America, and least in Africa. The key to this decline in poverty and increase in prosperity was a steep decline in commitments to statism, an increasing willingness to subject national economies to international competition and market forces, and a more predictable and stable policy environment.

If we go back twenty years in Latin America, we see a continent still deeply mired in the results of a century of bad economic policy, compounded by political uncertainty and corruption. The past twenty years, however, have seen some critical progress in overcoming this legacy, with noteworthy success stories and broad glimmers of hope and possibility in every part of the Americas. There remain huge problems, not least in the attitudes of US officials and legislators to the prospect of further underwriting these developments through trade agreements, but the future continues to look brighter than the past. From Chile, Mexico, and Costa Rica to Uruguay, Guatemala, and Colombia, the story is of advances, but also of unfinished journeys. Unfortunately, some countries have also stepped off the path of reform, Venezuela and Bolivia being the most recent examples, but Ecuador and Argentina also look shaky. In each of these cases, the underlying problem is less a matter of failure than of containing rising expectations. It is also symptomatic of another problem: lack of predictability and stability. Private markets thrive on stability and stagnate in the face of unpredictable change. In Latin America, a long-term, stable, and predictable policy framework has been rare.

Brazil, Latin America's largest economy, also remains a problem. Its president, Luiz Inácio Lula da Silva, is carving out a role for Brazil as spokesman for developing countries, including by founding the G20 group to lobby rich countries to open up farm trade. His government is playing a more active role across

South America and seeking a permanent seat on the UN Security Council. To date, however, Lula's ambitions have made little difference to Brazil's performance or to its power to realize them. Under Lula, Brazil remains committed to a view of economic development and the role of trade and the multilateral trading system that relies on special and differential treatment in favor of developing countries. The economic future of Brazil, and that of the rest of Latin America, would look considerably brighter if its leaders would finally accept that special and differential treatment is a trap rather than a panacea. More about this later.

Until the 1980s, Latin America was treated as a hopeless backwater of some political but little economic interest to business and government alike in North America and Europe. Endemic corruption, human rights abuses, civil war, and black markets, all products of the political and economic policies pursued throughout the region, dampened enthusiasm for closer political and economic relations. Not all the countries of the region were as quick and as committed as others to an open program of political and economic reform, but the pattern of change was surprisingly similar throughout the region by the 1990s and its power proved infectious. Even as obscure and backward a country as Honduras adopted the new approach. Wrote its President, Rafael Leonardo Callejas, in the *Wall Street Journal* in January 1992:

> In Honduras, we have opened our market dramatically, reducing import tariff rates from a maximum of 135 percent in 1989 to a current maximum of just 20 percent. Price subsidies have been eliminated. Foreign-investment regulations are being liberalized. Interest rates and the value of our currency are now set in response to market forces. Government spending has been brought under control: The fiscal deficit declined to an estimated 4 percent of gross national product in 1991, from 9.2 percent of GNP in 1989. Honduras is no longer in arrears on its foreign-debt obligations. We are controlling inflation, and our economy has resumed growth. By implementing adjustment policies, Central Americans are demonstrating their determination to integrate themselves into the global economy.[5]

The road Latin America has to travel, however, remains long and arduous. The damage caused by decades of political dictatorship and economic interventionism runs deep. The corruption that had become a way of life did not disappear overnight. But the basics remain: the people and the resources. The development problems faced by many of the countries of the region are not those of Africa or of Eastern Europe. Many countries could count on a large group of well-educated intellectuals, managers, and other elites. The infrastructure is run down but not absent. The debt load was crippling but with a will is being managed.

In short, the gloomy picture of stagnation, recession and inflation that characterized most of the countries of Latin America and the Caribbean gradually gave way in the 1990s, although there were some contradictory signs and in many cases the recovery was marked by fragility. Furthermore, the region still suffers from the great mass of backlogs and shortcoming caused by the legacy

of long-standing inequalities, now increased by the social cost of the adjustment. What more can economists and experience suggest? To answer that question, we turn to another sign of hope: the coming of age of economic policy advice.

Economic policy advice comes of age

One of the saddest stories of our times is the continuing willful ignorance of well-intentioned people about the basic facts, not theories, of economics. That was perhaps excusable fifty years ago, when economists continued to be widely divided in their analyses, theories, and prescriptions. That is no longer true. The economics profession has now reached the stage that medicine had reached by the 1930s. By that time, a visit to almost any doctor would do more good than harm; as little as thirty years earlier it was still the other way around. Today, doctors can not only diagnose reliably what's wrong 95 percent of the time, but can also prescribe a cure that will work 95 percent of the time. My grandparents all died in their early sixties – reaching a normal age for that time. Now I play golf with people in their eighties, survivors of cancers, heart attacks, pneumonia, and other former certain killers.[6]

A generation ago, governments could not be sure that consulting an economist would have a prophylactic effect. More than likely they would consult a Keynesian or a practitioner of some other school enthralled by the dead hand of the planning ideology. Such economists would do more harm than good. Brink Lindsey at the Cato Institute in Washington has written a wonderful obituary for the planning ideology – *Against the Dead Hand: The Uncertain Struggle for Global Capitalism.*[7] I recommend it highly. Unfortunately, this ideology, while banished from economics departments, continues to beguile union halls, church basements, political science departments, and liberal politics.

Among professional economists, the issues that excite activists and non-governmental organizations (NGOs) are of little interest or concern: they are settled issues. Economists as politically diverse as Paul Krugman and Milton Friedman do not disagree on the role of open economies, free enterprise, and well-functioning markets. It is only populists, media personalities like CNN's Lou Dobbs, well-meaning NGO activists, and some politicians who continue to believe that markets should be closely regulated to achieve political rather than economic ends. The results are usually disastrous.

Too many activists remain dedicated to what might be called the Keynesian conceit: that government planning brings superior results than the anarchy of the market. The evidence for this conceit has become steadily less persuasive and is generally marshaled only by non-economists pretending to use economic arguments. That being said, it remains true that economists have done a miserable job of communicating their consensus to the rest of the population, particularly to well-intentioned NGOs and political activists. They continue to practice what British economist David Henderson called "do-it-yourself economics." Henderson notes:

> More than two centuries have passed since the publication of Adam Smith's great treatise, *The Wealth of Nations;* and trained economists are now well established, not just in universities and research institutes, but also in business enterprises, civil services, and the councils of presidents and prime ministers.... Yet DIYE [do-it-yourself economics] has not become a curiosity of the past.... Ideas and beliefs which owe nothing to recognized economics textbooks still retain their power to influence people and events.[8]

He concludes that economics must be one of the few academic disciplines in which the professionals have failed to drive out the amateurs and in which "pre-scientific" notions continue successfully to influence serious opinion.

In a similar vein, writing about the continued appeal of do-it-yourself economics in developing countries, and skepticism about the benefits of open economies and competitive markets, World Bank economist Bernard Hoekman notes:

> The fact that many low-income countries have not been able to use trade as an engine of growth reflects a mix of domestic and international constraints: market access barriers at home and abroad, complemented by the absence of an enabling environment. Inefficient distribution and transport services, infrastructure weakness, corruption, distorted tax regimes, and so forth, can all be major obstacles to investment and employment expansion. Given the plethora of constraints, priorities need to be set by countries. These will often be only indirectly related to trade, if at all. Those that are trade-related will frequently not be addressable through the WTO.[9]

Some may accuse me of practicing economics without a license. I plead guilty. My economics is the result of experience and wide reading rather than formal training and licensing. Nevertheless, I am satisfied that we have reached the point where economists can give governments sound advice whose efficacy has been confirmed by broad experience. Today, almost any graduate of a modern economics faculty can provide useful advice. The profession has reached a broad consensus on a range of issues, including diagnosis and prescription, based on both theoretical models and empirical observation. John Mueller, in his excellent book – *Capitalism, Democracy, and Ralph's Pretty Good Grocery*[10] – sums up these basic propositions quite well:

- The growth of economic well-being should be the dominant goal of public policy – not income redistribution, but economic growth.
- Wealth is best achieved through exchange rather than through conquest, on the basis of markets, rather than politics.
- International – and domestic – exchange should be free, the result of willing buyers and sellers getting together.
- Economies do best when governments leave them substantially free.

Against this background, let us now turn to the broader lessons learned from the past half-century of trying to use trade negotiations to effect economic reform, generally and in developing countries.

Economic policy, trade negotiations, and developing countries

Virtually all economists agree that an open, rules-based international economy is a critically important contributor to economic growth and prosperity. The foundation for both rests in the GATT/WTO regime. It is built on the premise that individual, national, and global economic prosperity can be advanced by removing barriers to the international exchange of goods and, more recently, services, capital, and technology. The regime does this in two important ways: by maintaining a body of agreed rules and procedures to govern trade among its members, and by sponsoring and facilitating periodic negotiations to further liberalize trade. Members have approached trade liberalization and rule development as a progressive project – as a project that could, largely for political reasons, not be implemented immediately but could be addressed progressively through periodic negotiations aimed at further reducing barriers and strengthening the rules.

The principal benefit derived from GATT/WTO membership has always been support – through rule development and enforcement – for domestic economic policy reform, a benefit that accrues whether a country is in the early or more advanced stages of economic development, high income or low income. Indeed, it can be argued that because developed countries already enjoy high per capita incomes, the benefits for individuals from domestic economic reform and strengthening of liberal policies are probably higher in lower-income, lesser-developed countries. In both types of countries, however, gaining and maintaining support for open, market-oriented policies can be politically difficult, underlining the importance of the secondary benefit of membership: improved export market access achieved through negotiations and underwritten by the rules and procedures.

Perversely, the first benefit is undercut by many of the traditional special and differential treatment provisions that allow developing country members to avoid full application of the rules, such as they are, while the second is undermined by a lack of either developing country capacity or the will to participate fully in market-access negotiations.[11] GATT/WTO rules make it more difficult for governments to acquiesce to domestic protectionist pressures; special and differential treatment dulls this discipline, by not providing counterweights to domestic pressures to avoid growth-oriented policies.

The perversity of traditional special and differential treatment lies in part in the trade regime's commitment to the process of mercantilist bargaining. While mercantilist bargaining proved critical to gaining political support for economically beneficial but politically risky liberalization, it was based on a fundamental fallacy: that opening one's market involved "concessions" for which one needed

to be "paid." The GATT worked for the OECD countries because they were prepared to pay by opening up their own markets in order to gain better access to the markets of other countries. The politically necessary process of pursuing mercantilist export opportunities resulted in economically beneficial commitments to rules and to opening one's own markets, leading to competition, consumer choice, economic growth, and other benefits. Developing countries, by being excused from the need to pay for new export opportunities, harmed themselves in two ways:

1. They added to the difficulty of convincing developed countries to open their markets to products of export interest to developing countries, particularly temperate-zone and tropical agricultural products, and standard-technology, labor-intensive consumer products such as textiles, clothing, footwear, toys, electronics, and more.
2. They did not open their markets to more competition, a step that may have been politically attractive, but was economically short-sighted. By supporting each other's short-sightedness through such forums as the UN Conference on Trade and Development (UNCTAD) and the UN Industrial Development Organization (UNIDO) and through special and differential treatment in the GATT, they ensured that all but a handful of developing countries would gain less than was available to them through active participation in the GATT.

Even more perversely, special and differential treatment contributed to corruption. Many developing countries have traditionally relied on the provisions in GATT Article XVIII permitting protection to safeguard the balance of payments for development purposes. Most developing countries maintain non-convertible currencies with exchange rates fixed at inappropriate levels, leading to chronic balance-of-payments problems. The instrument of choice often used to conserve scarce foreign exchange is licensing of both exports and imports, much of it applied on a discretionary basis. Nothing corrupts more quickly and thoroughly than a discretionary licensing scheme administered by underpaid officials.[12] Thus, in many developing countries, reliance on GATT Article XVIII to shelter their economies from international competition has not only had the expected negative effects of closed economies, but has also had the even more depressing corollary effect of fostering thoroughly corrupt and corrupting trade regimes.

Pursuit of special and differential treatment by developing countries also contributed, indirectly but perversely, to their status as second-rank players with little influence and potential targets of discriminatory policies, including the notorious textiles and clothing regime, the raft of grey-area measures such as "voluntary" export restraints and "orderly" marketing arrangements, increasing resort to contingency protection measures, and the stubborn resistance of agricultural protectionism, justified on the basis of waivers, questionable applications of the rules, and other abuses. This reverse special and differential treatment undermined the development objectives of many developing countries

both by frustrating their export ambitions and by justifying their less-than-full embrace of the rules and opportunities the GATT offered.

Historically, governments of advanced developed countries have been prepared to extend special and differential treatment in favor of developing countries more as a political gesture than out of any conviction that it would make a material difference. This had the contrary effect of promoting cynicism about their interest in encouraging economic development through trade. This cynicism was reinforced by the willingness of developed countries to apply reverse or negative special and differential treatment to the trading interests of developing countries. Most pre-WTO positive special and differential measures, for example, were based on voluntarism and the record of compliance is very weak,[13] while negative special and differential treatment continued to be applied with undiminished zeal, despite rhetorical commitments to the contrary.

Nevertheless, despite this less-than-stellar record, much of the public discourse regarding special and differential treatment continues to assume that there is a strong case establishing its efficacy. If there is any justification for special and differential treatment in the WTO, it revolves around the capacity of developing countries to implement their WTO commitments and the priority they should assign to gaining such capacity. Arguments that posit that the rules of the game are currently stacked against the interests of developing countries and that the rules should be changed to meet the development aspirations of developing countries do little more than perpetuate a counterproductive approach to integrating developing countries more fully into the global trade regime. Developing countries can only "secure a share in the growth of world trade commensurate with the needs of their economic development" (in the words of the Doha Declaration, paragraph 2) by taking take full advantage of the trade regime. By contrast, further weakening the regime to accommodate additional ill-conceived special and differential measures will not help developing countries but will harm the trade regime, including the trade interests of developing countries and especially the least-developed among them.

The Doha round, the FTAA, and bilateral free trade

At the turn of the century, the world was awash in trade negotiations. From free trade in the Americas to free trade in the Asia-Pacific, the WTO's Doha Development Round, US negotiations with Chile, Central America, Singapore, Australia, and countries in the Middle East, EU negotiations with MERCOSUR, Mexico, and the Andean countries, and Canadian bilateral negotiations with Central America and Singapore, the number of intergovernmental trade agreements was poised to rise exponentially.

Five years later, only a few of these have been successfully concluded, largely bilateral efforts such as the US–Australia agreement. The wider the participation, the more difficult success seems to be. There is now broad consensus that the Free Trade Area of the Americas proved a bridge too far: too many players with too many incompatible objectives. Nevertheless, the journey has

not been without benefits that can be put to work to the advantage of many in Latin America. If nothing else, the FTAA experience placed serious trade policy on the agenda in Central and South America. Negotiating groups, while unable to reach consensus, did prove a first-class learning experience for officials throughout the Americas. But with not enough in it for the United States and without a Brazil prepared to pursue a serious role that put emphasis on results rather than pretensions, it was doomed from the start. The FTAA's time, I am afraid, has come and gone.

Lack of progress on an FTAA, however, is far from unique. Even more fundamentally, multilateral negotiations under the auspices of the WTO have not fared much better. Starting with the 1999 ministerial meeting in Seattle, ministers have found it increasingly difficult to come to consensus on anything other than commitments to work programs and study projects. At their 2001 meeting in Doha, Qatar, the shadow of 9/11 was sufficient to create a fragile consensus to start a new round of multilateral negotiations. The 2003 meeting in Cancun and the 2005 meeting in Hong Kong, however, proved that the consensus was both fragile and short-lived. The verbose Declaration adopted at the conclusion of the Hong Kong meeting put a point on it.[14] After five days of round-the-clock negotiations trying to address the absence of agreement on virtually every issue on the negotiating table, the WTO throng left town with little more than an agreement to keep talking.

The principal reason for the lack of progress lies in a fundamental impasse regarding the object and purpose of multilateral trade negotiations. It divides "satisfied powers," essentially developed countries, from "dissatisfied powers," largely the developing countries. The satisfied powers are interested in preserving the vitality of the WTO as a set of rules and procedures, but not in major new trade liberalization if it comes at high domestic political cost. The opposition to trade liberalization in developed countries is now confined to isolated sectors, such as textiles and clothing and agriculture, but it is not counterbalanced by strong domestic support for liberalization. Such support has evaporated in large measure due to the success of previous negotiations and the consequent absence of an attractive negotiating agenda. The dissatisfied powers generally believe, not without reason, that previous rounds of trade negotiations have ignored their interests while imposing significant new obligations upon them – for example, intellectual property protection. Their objective in the Doha Round is to obtain significant reductions of developed countries' trade barriers on agriculture and low-cost manufactured goods, such as clothing. They are also seeking effectively to renegotiate some aspects of current WTO rules and refuse to take on the two issues, investment and competition policy, that might have generated some support in developed countries. Until the impasse between countries that have low ambitions for the evolution of WTO rules and those who seek a radical refocusing of its rules is resolved, progress will be difficult.

Agriculture is a case in point. The most serious obstacle to progress on agriculture resides in a paradox: as the economic importance of agriculture declines, its political weight increases. In the OECD countries as a whole, agriculture now

accounts for less than 5 percent of GDP and even less of employment. Agriculture support programs may seem ruinously expensive, but the amounts involved are still modest in terms of overall budgets; the costs to consumers through higher prices are sufficiently well camouflaged to muffle any potential consumer backlash. For example, the massive subsidies enjoyed by EU farmers may account for 40 percent of the EU's budget, but in reality adds up to only 2 percent of total government expenditure in the EU countries. For all its diminishing economic weight, the farm sector enjoys powerful emotional support among electorates. If subsidies were reduced and domestic markets opened to international trade, a major downsizing of agriculture would occur in most of the EU and some Asian countries, as well as in certain sectors in Canada and the United States. While a compelling economic case can be made that the EU should get out of growing sugar beets, the United States out of cotton, rice, and cane sugar, Korea and Japan out of rice, and Canada out of more than local production of dairy and poultry products, no politician hopeful of re-election would support such a step. The political costs are too high and the economic benefits too low.

Agriculture is not the only ideological divide. The quixotic attachment of developing countries to special and differential treatment is a serious systemic barrier to progress. Nevertheless, the Hong Kong Declaration ritualistically reaffirms "that provisions for special and differential (S&D) treatment are an integral part of the WTO Agreements and that all S&D treatment provisions will be reviewed with a view to strengthening them and making them more precise, effective and operational" (paragraph 35). The justification for S&D treatment lies in the perception that only developed countries can fully benefit from international trade, and developing countries cannot take full advantage of the opportunities created by liberalization and should thus be allowed to shelter their economies from the full application of the trade rules. US analyst Gary Hufbauer sums up the real reason with characteristic directness: "everyone 'knows' that trade ministers representing poor countries can't be asked to dismantle their barriers because ... well, because they like to use muddled infant industry arguments to confer favors on well-connected constituents."[15]

In Hong Kong, the arguments became even more tortured. The laudable elimination of export subsidies, ministers declared, should not result in higher costs for food-importing developing countries. The reduction of trade barriers should properly reflect the need to compensate developing countries for the erosion of trade preferences. The least developed countries should benefit from tariff-free and quota-free market access, but only to rich-country markets and to those developing-country markets that can "afford" to give such access, notwithstanding World Bank studies demonstrating that the potential benefits of remaining trade liberalization are greatest in trade between developing countries. Prior to his selection as WTO Director General, Pascal Lamy called for a "free round" for developing countries – that is, they should not be expected to lower their trade barriers and reduce their subsidies. At Hong Kong, it became brutally clear that a free round for developing countries was not on the table. At least on that point, ministers got it right.

Much as WTO Director General Pascal Lamy sought to recalibrate expectations for Hong Kong, governments need to recalibrate the focus of their multilateral trade policy by separating the fate of negotiations from the fate of the WTO. Historically, the multilateral trade system has had two major roles: to provide a rules-based framework for the conduct of international trade, and to sponsor multilateral trade negotiations. After eight rounds of successful negotiations resulting in sustained reductions in trade barriers to the markets of the major trading countries, the system now involves a complex, multifaceted set of rules disciplining government regulation of the full range of international trade transactions. The twenty-three governments that brought the GATT into force in 1948 became the eighty governments that launched the Uruguay Round in 1986, the 142 that agreed to the Doha Declaration in 2001, and the 149 that gathered in Hong Kong. Throughout this successful half-century and more, the twin roles of maintaining a rules-based system and sponsoring negotiations have been carefully balanced. Since the founding of the WTO in 1995, the balance between rules maintenance and negotiations has shifted decisively to the former. The prestige and relevance of the WTO as the arbiter of international trade rules has grown, while its negotiating role has been assumed by regional and bilateral initiatives now pursued by virtually every WTO member. The result is that while the multilateral trade system is riding a crest of success, as attested by its growing prestige and membership, its members are looking elsewhere to pursue their negotiating interests.

Old ideas die hard deaths. The old idea is the "bicycle theory" of trade negotiations. It holds that the "bicycle" of negotiations has to move forward, if the multilateral system is not to fall over. The bicycle should be thrown into the dustbin of history. It is not regional and bilateral trade agreements that weaken the multilateral system; it is the insistence that successful multilateral negotiations and the vitality of the multilateral system as a whole are one and the same. As WTO members turn their attention to picking up the pieces from Hong Kong, they should recall that the multilateral trade system is not a goal but rather a means to an end. The goals of the system are clearly set out in the WTO preamble: rising living standards, full employment, and steadily growing incomes. Such goals have also been, and will continue to be, achieved through bilateral and preferential agreements, reducing the primary function of the multilateral trade system to guarding and adjudicating application of the multilateral rules. This function will remain important only so long as the members have faith and confidence in the ability of the system to deliver. At some point, later rather than sooner, the Doha Round will conclude. However that conclusion measures up against the lofty ambitions set for the round, it is less critical than that the multilateral trade system remains unimpaired as an enforceable set of rules and procedures.

Conclusion: just do it!

In face of the solid record favoring open markets and the rather meager prospect of achieving the desired openness in Latin America through negotiations, what is to be done? There is only one answer: unilateralism. Do it, regardless.

For countries in the Americas, trade policy for the immediate future should start at home. The WTO, FTAA, and bilateral agreements are means that can be critical to helping governments do the right thing and reinforce domestic reform agendas, but in the final analysis, the reform has to start at home. The experiences of India and China are but the latest examples from Asia. Over the next few years, Latin American countries need to focus their energies on taking full advantage of what they already have: membership in the WTO and all the opportunities that this can entail. Only after they have fully implemented their GATT/WTO obligations and learned to pursue existing rights and opportunities should they look to bilateral, regional, and multilateral negotiations as ways to reinforce, validate, and accelerate domestic reform. In effect, that is what Chile, Mexico, and Costa Rica have done and what others also need to do.

This may be a politically difficult strategy, but all others promise at best short-term political gain for continued long-term economic pain. At one time, it might have been possible to isolate an economy from most others – to practice a form of autarchy – but no longer. The reality of global markets and communications provides governments with no escape. Their citizens will increasingly demand what they see others enjoying: better jobs, more development, greater access to consumer products, and more. To get there, the countries in Latin America need foreign investment, access to foreign markets, and competition at home. Trade negotiations are one way to pursue these three fundamentals but, in the absence of productive negotiations, unilateral action remains a realistic alternative. This was the route chosen by Hong Kong and Singapore. It is now being pursued, in part, by China and India. It is a route that is open to Latin America. My advice: take advantage of it.

It is a route that is not as difficult as it once was. The major markets of North America, Europe and, to a lesser extent, Asia are generally open, and a will to tackle agricultural markets is finally emerging. The barriers that remain, while politically difficult, are at the margin in their economic impact. The cautious pragmatism that marked Canadian, US, and European trade policy in the 1950s through 1970s has now paved the way for developing countries to take a bolder approach. The key is for them to open their own markets to foreign competition and the beneficial effect of foreign goods, services, and capital. Reciprocal negotiations are the preferred way to do this, but making unilateral commitments is a reasonable second-best alternative, and far superior to a stubborn insistence that the problems of economic development lie in North America and Europe and that poor countries should be excused from adopting sound trade policies.

Notes

1 Earlier presentations at Baylor included: "A Canadian Perspective on the 1987 Canada–United States Free Trade Agreement," in Glen E. Lich and Joseph A. McKinney, eds, *Region North America: Canada, United States and Mexico* (Waco: Baylor University, 1990), and "Whither NAFTA: To Expand or to Deepen?" in Joe McKinney and Melissa Essary, eds., *Free Trade for the Americas: Issues in Economics, International Trade Policy and Law* (Waco, Texas: Baylor University, 1995).

2 Trefler, D. (2005) "International Trade: 20 Years of Failed Economics and Successful Economies," in William Robson and David Laidler, eds, *Prospects for Canada: Progress and Challenges 20 Years after the Macdonald Commission* (Toronto: CD Howe Institute, 2005), p. 119.
3 Blank, S. "It is Time for Canada to Think Carefully about North America," *Embassy*, September 7, 2005.
4 Bhalla, S. (2002) *Imagine There's No Country: Poverty, Inequality, and Growth in the Era of Globalization*, Washington: Institute for International Economics, p. 200.
5 *Wall Street Journal*, January 31, 1992, p. A15.
6 I am relying here on a wonderful book I read a few years ago on the evolution of medicine by a Canadian historian, Edward Shorter, *Bedside Manners: The Troubled History of Doctors and Patients* (New York: Simon and Schuster, 1985). His theme, that doctors' bedside manners had deteriorated as they concentrated on the disease rather than the patient, is perhaps also apropos. Economists have similarly become too enamored of the analytical trees of their craft while losing sight of the forest of broader economic policy.
7 Lindsey, B. (2002) *Against the Dead Hand*, New York: John Wiley & Sons. It should be required reading for all parliamentarians and legislators.
8 Henderson, D. (1986) *Innocence and Design: The Influence of Economic Ideas on Policy*, Oxford: Basil Blackwell.
9 Hoekman, D. (2002) "Strengthening the Global Trade Architecture for Development," World Bank Research Working Paper No. 2757.
10 Mueller, J. (1999) *Capitalism, Democracy & Ralph's Pretty Good Grocery*, Princeton: Princeton University Press.
11 It is these two facts that allowed economist Andrew Rose to reach the wholly predictable conclusion that membership in the GATT/WTO has made little difference to most of its membership. Of course, it would have been helpful if he had integrated these facts into his analysis and conclusions rather than leaving the wholly erroneous impression, reinforced by superficial media stories, that GATT/WTO membership makes little difference to a country's trade performance. It does make a difference, a huge difference, to its economic performance by expanding the opportunity for trade, but only if a country takes its obligations seriously and takes full advantage of the opportunities the regime offers. Most developing countries – and thus most WTO/GATT members – have chosen otherwise. See Andrew Rose, "Do we really know that the WTO increases trade?" CEPR Discussion Paper 3538, and "Weighing up the WTO: Does the world's free-trade club actually work?" *The Economist*, 21 November 2002.
12 See, for example, Kimberly Ann Elliott, ed., *Corruption and the Global Economy* (Washington: Institute for International Economics, 1997).
13 See WTO document WT/COMTD/W/77/Rev. 1/Add.4 of 7 February 2002 for an inventory demonstrating the low level of utilization of many of these provisions.
14 The Declaration can be found at www.wto.org/english/thewto_e/minist_e/min05_e/final_text_e.htm. Despite its impressive length – 57 paragraphs, 6,100 words, and six lengthy annexes – it is meager fare indeed, a triumph of process over substance. There are only two firm commitments, one to eliminate export subsidies on cotton by the end of 2006 and the other, to eliminate all agriculture subsidies by 2013.
15 Hufbauer, G. (June 2005) "Inconsistency between Diagnosis and Treatment," *Journal of International Economic Law*, 8:2, 293.

3 New trade strategies in the Americas

Sherry M. Stephenson[1]

Losing a historic opportunity?

A truly historic opportunity to create an economically integrated Western Hemisphere is in the process of being lost once again. The Western Hemisphere (WH) came closer than ever before to the realization of this two-century-old dream during its eight years of negotiating the Free Trade Area of the Americas (FTAA) between July 1995 and January 2004, but over the past two years the opportunity and the momentum have been slipping through the fingers of the participating governments.

Why the stalemate in the hemispheric integration process?

As originally vetted, the FTAA is the most ambitious free trade initiative of the post-war trading system. Never before have so many countries of such widely diverse sizes and levels of development joined together to negotiate a reciprocal free trade pact. Under the best of circumstances, crafting such a pact would be extremely challenging. But negotiators have not been lucky. Their task has been complicated by events of financial crises and political turmoil that have beset many Latin American countries over the past decade, the new security imperatives of the post-9/11 world, and now the prospective expiration of US Trade Promotion Authority in June 2007.

Over the past twelve months pressing economic and political problems at home have beset Latin American governments; no fewer than twelve presidential elections were held in Latin America during 2006. All countries face the challenge of adjusting to rapidly changing conditions in the global economy generated by technological innovation and by the emergence of the Chinese trading juggernaut. Not surprisingly, questions have been raised by previous and newly-elected governments as to whether they can fulfill their lofty Summit of the Americas promises – or whether they even still want to do so.

A battle of influence has also been underway between the two largest countries in the hemisphere, Brazil and the United States, both of whom have changed their perspective on trade and hemispheric integration since the FTAA process began after the first Summit of the Americas in December 1994. More

than a decade later, these two economic giants, whose support and leadership are necessary if the dream of integrating the Americas is to become a reality, find themselves less than fully convinced about the desirability of a hemispheric free trade agreement.

Other countries in Latin America have turned away from the FTAA to embrace other, rival paths to economic integration, such as the Boliverian Alternative for the Americas or ALBA, an initiative of Venezuela in 2004 that was adopted in April 2006 by Bolivia and Cuba in the form of a People's Trade Agreement. Under the ALBA vision, trade constitutes only one component of an economic relationship, of which the most important elements are economic cooperation and product complementarity.[2] This alternative vision opposes neoliberal theories of free trade and comparative advantage and eschews a market-driven approach in favor of a state-driven one. Under the agreements that have been concluded through ALBA, energy is a critical component.

The stalemate in the economic integration process derives from the fact that countries in the Western Hemisphere no longer appear to define their trade priorities along the same lines. Trade policy has also more clearly become an integral part of foreign policy, thus making it more susceptible to political influences and decisions. Priorities with respect to trade coincided at the time of the Summit of the Americas in Miami in December 1994 during the period of the "Washington consensus" and remained convergent for seven years, as the FTAA negotiations moved forward. However, two events occurred in 2002 that in hindsight represent a watershed with respect to the definition of the national interests of Brazil and the US in trade.

In the United States, the summer of 2002 was marked by Congressional passage of Trade Promotion Authority (TPA) – the first time that the President had been able to obtain this required legislative approval to engage in trade negotiations since it had expired in 1993 at the conclusion of the Uruguay Round, nearly ten years earlier. This gave US negotiators a new lease on life, but a very short leash within which to maneuver, as the content of any new trade agreement was already broadly defined by the terms of the TPA Act. With this in hand, the USTR turned to the pursuit of a very ambitious trade agenda in bilateral Free Trade Agreements (FTAs) – the post-NAFTA template – that required not only market opening but also the adoption of far-reaching rules in behind-the-border areas. Institutional transformation and strengthening in partner FTA countries became one of the stated goals of US trade policy. Additionally, US negotiators were given little room to compromise on sensitive issues such as market access liberalization for certain agricultural products, trade remedy procedures and mobility of labor as part of a services chapter.

In Brazil, President Lula da Silva of the Workers Party was elected in the fall of 2002, the first President from a working class background, running on a more populist platform than any previously seen. Although President Lula's government has followed an orthodox line with respect to monetary policy, it has preferred to adopt a more strident rhetoric on trade, associating the FTAA process

with a perceived dominance by the United States and the imposition of a negotiating agenda and objectives that no longer fit national aspirations.

Brazil's new government concluded early on that it had little interest in proceeding with the FTAA in the then existing framework of negotiations, so attempted to reshape the negotiating framework and objectives. Brazil's redefinition of its national interest coincided with its political ambitions to exercise leadership in South America. Priority of the Lula Government in the trade arena was given to the Doha Development Agenda, or the ongoing round of multilateral trade negotiations under the WTO, where Brazil felt that the prospects for liberalization in agricultural trade were more promising. In parallel, Brazil pushed for a regional deal with the European Union over one in the Western Hemisphere where it felt that the presence of the United States would dominate the trade agenda.

At the insistence of Brazil and its MERCOSUR colleagues, a new framework for the FTAA negotiations was developed at a meeting of trade ministers in Miami in November 2003. The framework departed from all previous trade negotiations and regional agreements in that it called for a core of concessions focusing on market access (lower tariffs and non-tariff trade barriers on goods, including agriculture) accompanied by minimum obligations that would be required of all countries in the other negotiating areas, alongside a discretionary adherence by countries to deeper and more far-reaching obligations in areas of their choice, such as trade in services, strengthened intellectual property provisions, government procurement rules, investment, and transparency. These are areas that have been highlighted in recent regional and bilateral free trade agreements (RTAs) in the hemisphere.

This two-tiered approach (a common tier of mutual but minimal obligations focused on market access, and an upper, voluntary tier of strengthened obligations in various trade-related disciplines) was immediately dubbed "FTAA à la carte" or "FTAA lite." Under this approach, both tiers or both levels of disciplines were to constitute the FTAA. However, the notion of a "single undertaking" that had been one of the cornerstones of the FTAA negotiating process since the beginning was cast aside.

Problems immediately became apparent when FTAA participants tried to make this new framework operational, the main problem being that the interests of the US and Brazil are very much at opposite ends of the spectrum. The lower tier, with its emphasis on market opening, particularly for agricultural products, is the important one for Brazil. But for the United States it is the upper tier of strengthened disciplines, especially in the areas of services and investment, where US competitiveness is deemed to be greatest, that are the focus. After one formal but unsuccessful attempt to develop procedures for the negotiations under this new approach in February 2004, moving forward with the negotiations has since proved impossible. The United States and Brazil, as co-chairs of the negotiations, have been unable to come to an agreement on how to proceed concretely. Indeed, there has been no substantive FTAA negotiating meeting since the Miami framework agreement was agreed in 2003.

US response to the FTAA stalemate

The US and Brazil have both responded to the stalemate in the FTAA talks with active diplomatic initiatives. The main US response has been a series of bilateral free trade negotiations with several Latin American countries. In its post-NAFTA trade agenda, as evident in the revised and updated template of FTAs that have been negotiated by the USTR since 2002, the US has developed an elaborate structure of a large number of minimum prerequisites for domestic law in various trade-related areas that its FTA partners must accept. These include strengthened intellectual property laws and enforcement procedures, standards and technical regulations, procurement procedures, strengthened regulatory frameworks for telecommunications and professional services, transparency requirements in domestic laws for publication, prior comment and review, and strengthened dispute settlement procedures. Although the US prerequisites are not as extensive as those of the EU, they nonetheless constitute a major set of changes to internal laws and institutions that pose ambitious challenges to FTA partners.

As of mid-2006, the United States has completed or is in the process of negotiating free trade agreements (FTAs) with the following countries in the Americas: Chile, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, the Dominican Republic, Panama, Peru, Colombia, and Ecuador. This is in addition to the NAFTA with Canada and Mexico. The only countries missing in this growing FTA web are those in the Caribbean, along with Venezuela, Bolivia, and the four countries of MERCOSUR (Brazil, Argentina, Paraguay, and Uruguay). All of these agreements include, or will include if consummated, an extensive array of provisions that reflect the original aspirations of the FTAA but that were made discretionary under the Miami 2003 FTAA framework.

Once the United States successfully concludes ongoing FTA negotiations with the Latin American countries mentioned above (other than MERCOSUR members and Bolivia), it will have achieved free trade with countries that already account for 88 percent of its two-way trade in the hemisphere.

Brazil's response to the FTAA stalemate

For its part, Brazil has adopted a similar proactive unilateral trade strategy. It has signed skeletal FTAs with most of its LAC neighbors (although these cover goods only and exclude both services and investment, as well as other trade-related issues); product-specific deals with Mexico and China; and is negotiating a free trade pact with the European Union (whose progress has been lagging). Brazil has been instrumental in deepening the integration efforts of MERCOSUR, and finally ratified the Services Protocol in late 2005, bringing it into effect at the regional level after eight years. Other regional protocols are being reactivated as well. To date, the Brazilian strategy has scored political points in Latin America, but has made little progress in advancing Brazilian export interests in major industrial markets.

Brazil has sought to expand and reinforce MERCOSUR, and to move it towards becoming the South American Community of Nations (a southern hemispheric alternative to NAFTA that was launched by the Government of Brazil in Cuzco, Peru, on 8 December 2004). Venezuela was invited to become a full member of MERCOSUR on 9 December 2005 and promptly accepted. Later that month, Evo Morales was elected President in Bolivia. The Argentinian Chair of MERCOSUR's Permanent Representatives Commission promptly announced a proposal for Bolivia to join MERCOSUR as a full member under the same conditions.[3] With Chile and other members of the Andean Community already associates, and possible future full members, this expansion sets MERCOSUR well on the path towards its transformation into Brazil's goal of the South American Community of Nations. Additionally, MERCOSUR is soon set to sign an economic cooperation agreement with Cuba.

Venezuela, Argentina, and Brazil make up about half of Latin America's population and GDP. The addition of Venezuela to the regional grouping should provide another pole of economic influence to the strong bilateral relationship between Argentina and Brazil. Venezuela should also bring needed cash from its plentiful oil reserves to finance development projects in this grouping. Already, a special development fund in the amount of $50 million was recently established to deal with the concerns of the smaller members.[4]

Although Argentina under President Kirchner's government has been fairly lukewarm to the creation of the South American Community of Nations, preferring instead to focus on expansion of MERCOSUR, nonetheless it has gone along in sharing the principle of South America-wide integration, At the Cuzco summit, President Chávez applied his flair for metaphor to the process, calling it a train with "a political locomotive and a social flag, rolling on economic rails with culture as its fuel."

Brazil's counter to the US negotiation of regional bilateral FTAs has thus been through focusing on creating a South American identity and economic space. It has, however, sought this regional expansion based more on a political and social platform. Some commentators have expressed the view that MERCOSUR is now undergoing not only a revival but a reorientation, moving from purely a commercial agreement to a more social integration process, rather than an economic one. Like the US, Brazil's initiatives also clearly carry with them foreign policy overtones.

At one point Brazil and its MERCOSUR partners suggested negotiating a bilateral FTA with the United States. This idea to date has been rejected by the United States, presumably because it would not include all of the areas that the US Trade Policy Authority Act requires in a regional agreement, and the United States would presumably not wish to provide an example within the hemisphere of an "incomplete" FTA. Additionally, such an agreement would eliminate any incentive for MERCOSUR members to move forward at some point with a revival of the FTAA negotiations.

The Caribbean response

CARICOM has been concerned about the progress of the proposed thirty-four-nation hemispheric free trade agreement since negotiations broke down in February 2004. Because of energy needs, Caribbean leaders are reconsidering the region's strategic alliances, including a possible free trade agreement with Venezuela as an alternative to the stalled Free Trade Area of the Americas (FTAA) negotiations. Venezuela has simultaneously sought to extend its strategic position in the Caribbean with its PetroCaribe oil initiative. Announcement of the CARICOM initiative was made by Prime Minister P.J. Patterson of Jamaica in Port-of-Spain, Trinidad, at a press conference in February 2006, following his chairing of the Caribbean Community (CARICOM) Prime Ministerial Sub-Committee on External Negotiations. Mr Patterson also added that there was a need for current bilateral agreements of CARICOM countries with Cuba to be converted into a collective agreement with that country. "All of us are required to examine what are the prospects of ever reaching a Free Trade Agreement for the Americas. Simply put, is the FTAA on or is it just going to be a mirage," he said.

The CARICOM Regional Negotiating Machinery (RNM) is conducting a study on the region's trade options for the future. At the twenty-seventh CARICOM Summit held in St. Kitts and Nevis in July 2006, the Head of the RNM, Ambassador Richard Bernal, disclosed that members were prepared to abandon the FTAA option as a route for regional trade and economic integration in favor of bilateral initiatives.[5]

CARICOM members will soon be pressed to define their trade relations as well with the United States as they face the expiration of the Caribbean Basin Trade Partnership Act (CBTPA) in September 2008. Without an FTAA option at that point, they will have to decide either to lobby for another extension of the CBTPA or to enter into a bilateral negotiation of an FTA with the US. This question has been at the center of all recent high-level meetings of CARICOM officials. Recent statements, including by Jamaica's Prime Minister, Ms Portia Simpson-Miller, are that the FTA route will be chosen. Bilateral negotiations were begun by CARICOM with Canada in 2003, designed to serve as a springboard and learning process.

Possible CARICOM–US FTA negotiations have been given impetus by the revival in April 2006 of a long-dormant Trade and Investment Council (TIC) grouping of CARICOM countries and the United States.[6] If CARICOM opens negotiations soon with the US, this will mark the last major subregion of the hemisphere to become a part of the web of bilateral agreements that both the US and Brazil have both been pursuing.

The FTAA and the summit of the Americas process

The Summit of the Americas process, begun in December 1994, establishes the common agenda of the democratically elected leaders of the hemisphere, and the

outcomes of the Summit meetings reflect their shared objectives, values, and responsibilities. The Summits provide a unique forum for the heads of state and heads of government in the Western Hemisphere to discuss solutions to common political, economic, and social problems in a multilateral and comprehensive way, and to establish periodic work programs and priorities to work on these issues.

The Fourth Summit of the Americas was held on 4–5 November 2005 in Mar del Plata, Argentina. While the theme of the Summit was "Creating Jobs to Fight Poverty and Strengthen Democratic Governance," several countries, led by the US, wanted to use the opportunity to reignite the stalled talks on the FTAA. Trade – more specifically the FTAA – thus proved to be the focus of much of the discussion and the most divisive issue at the Summit. This nearly led to a collapse of the final agreement in dramatic debate at all levels, including that of the heads of state.

Government officials argued over whether the final declaration would include key language on when high-level FTAA negotiations might resume. The turning point came when President Vicente Fox of Mexico suggested that the FTAA negotiations go forward with those "like-minded" countries that were prepared to negotiate a fully-fledged agreement, as per the original objectives of the San José Ministerial Declaration. Indeed, it seemed that several countries had made this suggestion before the Miami framework was accepted at the end of 2003. The paragraph on the FTAA finalized in the Summit Declaration of Mar del Plata (reproduced in Box 3.1) was agreed in the evening of the last day, and includes two options or points of view with respect to the FTAA – the first time that such a compromise has occurred at the Summit level since its inception. The first option reflects the position of twenty-nine countries that wish to go ahead with the FTAA negotiations and instructs officials responsible for trade from these countries to: "…resume their meetings, during 2006, to examine the difficulties in the FTAA process, in order to overcome them and advance the negotiations within the framework adopted in Miami in November 2003."

This expression of will by the large majority of countries in the hemisphere to move forward in the FTAA talks, even without the four MERCOSUR countries and Venezuela, is an important development. It paves the way for the possibility that the FTAA negotiations could resume among like-minded countries. It also is important in proving wrong the assertion that most Latin American countries see no value in a future FTAA agreement.

The question now will be, what happens next? Will the countries that expressed this opinion really be prepared to act upon it? Will Mexico or Colombia be prepared to act as the catalyst to move this process forward among the twenty-nine? And will the United States really go forward without Brazil and the other MERCOSUR countries in the most important trade initiative of this century?

Box 3.1 Text on trade from the declaration of Mar del Plata, November 2005

19. Recognizing the contribution that economic integration can make to the achievement of the Summit objectives of creating jobs to fight poverty and strengthening democratic governance:

A. Some member states maintain that we take into account the difficulties that the process of the Free Trade Area of the Americas (FTAA) negotiations has encountered, and we recognize the significant contribution that the processes of economic integration and trade liberalization in the Americas can and should make to the achievement of the Summit objectives to create jobs to fight poverty and strengthen democratic governance. Therefore, we remain committed to the achievement of a balanced and comprehensive FTAA Agreement that aims at expanding trade flows and, at the global level, trade free from subsidies and trade-distorting practices, with concrete and substantive benefits for all, taking into account the differences in the size and the levels of development of the participating economies and the special needs and special and differential treatment of the smaller and vulnerable economies. We will actively participate to ensure a significant outcome of the Doha Round that will reflect the measures and proposals mentioned in the previous paragraph. We shall continue to promote the established practices and activities in the FTAA process that provide transparency and encourage participation of civil society.

We instruct our officials responsible for trade negotiations to resume their meetings, during 2006, to examine the difficulties in the FTAA process, in order to overcome them and advance the negotiations within the framework adopted in Miami in November 2003. We also instruct our representatives in the institutions of the Tripartite Committee to continue allocating the resources necessary to support the FTAA Administrative Secretariat.

B. Other member states maintain that the necessary conditions are not yet in place for achieving a balanced and equitable free trade agreement with effective access to markets free from subsidies and trade-distorting practices, and that takes into account the needs and sensitivities of all partners, as well as the differences in the levels of development and size of the economies.

In view of the above, we have agreed to explore both positions in light of the outcomes of the next World Trade Organization ministerial meeting. To that end, the Government of Colombia will undertake consultations with a view to a meeting of the officials responsible for trade negotiations.

What is next? – after the Mar del Plata summit

In this new world of the twenty-first century, with the proliferation of bilateral FTAs and with the option of the FTAA still on the table, as well as the ongoing Doha Development Round under the WTO, Latin American and Caribbean countries find that their trade agenda must be much more complex than in the past. The regional options appear to be at the top of the list for many, as they pursue bilateral FTAs primarily with the United States, and secondarily with other LAC countries.

Growing adherence to the bilateral option

The temptation to bypass the difficulties inherent in multilateral and regional negotiations and open a direct path to the giant US market has led many countries to approach the United States for a bilateral FTA, and they have often found a willing partner. Even on the fringe of the Miami Ministerial Meeting in November 2003, the United States announced that it would open bilateral negotiations with some members of the Andean Community – Colombia, Peru, and Ecuador. In some ways, this announcement could be considered as important an outcome in Miami as the changed vision of the FTAA.

The United States accounts for three-fourths of total hemispheric trade, and for the largest share of total trade of the North American, Central American, Andean, and Caribbean countries. Moreover, much of that trade has already been, or will be, liberalized under existing and prospective FTAs. The United States already has implemented FTAs with Canada, Chile, and Mexico, and has ratified pacts with the five Central American countries and the Dominican Republic (negotiations that were ongoing at the time of the Miami Ministerial Meeting in late 2003). The DR-CAFTA was approved by the US Congress in 2005 and was to come into effect on 1 January 2006. There have, however, been delays in its implementation. An FTA between the US and Panama is near completion, but some issues of the negotiation are still outstanding as of mid-2006. Negotiations for FTAs between the US and Colombia and Peru have been finalized, and the agreements should be submitted to Congress in the second half of 2006. Negotiations with Ecuador have been put on hold for the time being. For CARICOM members, the Caribbean Basin Trade Partnership Act of 2000 (CBTPA) extends US unilateral tariff preferences to most Caribbean exports not covered by the Caribbean Basin Initiative (CBI) through September 2008. However, bilateral negotiations for an FTA between CARICOM and the US may well begin before the end of 2006. What will soon be left outside of formalized trade commitments or preferential arrangements with the largest hemispheric market will only be trade relations with MERCOSUR, Bolivia, and Venezuela.

The new template for FTAs

The form, complexity, and depth of bilateral agreements in the Western Hemisphere have evolved considerably over the past decade since NAFTA first blazed the trail in 1994.

- *Pre-NAFTA type Agreements*. These "Old Vision" agreements were simple in structure, focusing only on trade in goods. There were no provisions on rules other than for goods and no provisions related to dispute settlement.
- *NAFTA type Agreements*. These "New Vision" FTAs, largely modeled on NAFTA, have been negotiated in the Western Hemisphere since 1994. Comprehensive in their scope and approach to trade liberalization, these FTAs cover goods, services, and investment. They provide for ambitious and far-reaching objectives for behind-the-border integration, including substantive disciplines in new areas such as investment, government procurement, intellectual property rights, and competition policy, along with sophisticated dispute settlement mechanisms.

  Such agreements posed a major challenge to Latin American and Caribbean countries as they eliminated the rationale for the old type of integration among countries of similar levels of development. A new cost–benefit logic emerged for developing countries to link up with very large and competitive markets, propelled by the NAFTA experience and its beneficial impact on Mexico's growth. A concept of "new regionalism" began to emerge, typically involving small countries attempting to link up with larger ones (Canada, the United States or the European Union).
- *Post-NAFTA template for RTAs*. Post-NAFTA FTAs, or those signed after the US obtained Trade Promotion Authority (post-2002), go even farther than NAFTA in providing for deeper disciplines, greater transparency and levels of economic integration. The new FTAs have pushed the envelope in their inclusion of new and deeper rules on trade-related issues. Examples of such disciplines include: i) elimination of Antidumping disciplines and substitution of Safeguard disciplines (Canada–Chile FTA); ii) inclusion of chapters on Services, Investment, Government Procurement, and Competition Policy; iii) inclusion of provisions related to Transparency, Labor and Environmental issues, either in the form of side agreements or more recently through the inclusion of full provisions within the body of the treaty; iv) experimentation with different types of instruments to enforce the latter provisions, including cooperative actions, the possibility of monetary fines, mediation or formal dispute settlement.[7]

Interestingly, the bilateral FTAs based on this newer post-2002 template go farther than do the well-established custom unions in the Western Hemisphere (MERCOSUR, the Andean Community, the Central American Common Market, and CARICOM) to bring about economic integration, though in theory this should be a contradiction. While custom unions in the Western Hemisphere

have focused more heavily on political aspects of integration (especially MERCOSUR, the Central American Common Market, and the Andean Community), the economic content of trade liberalization has been much more curtailed and perfunctory than under the recent FTAs. Signs of movement towards change and of a new push to deepen intra-regional integration have been evident during 2006 within Central America and MERCOSUR, while CARICOM has brought into effect the Caribbean Single Market and Economy on schedule, as of January 2006.

Underlying objectives for pursuing FTAs

With such a wide array of FTAs coming into existence during the past decade and currently under negotiation, it is useful to examine the various reasons that might compel countries to favor the regional, especially bilateral or small-set FTA, over a multilateral or a hemispheric option. Objectives that countries in the Western Hemisphere have for entering into regional trade arrangements are of course varied, and may include:

- The consolidation of market-oriented policy reforms
- The enhancement of competitive positions on world markets
- The attraction of investment
- The advancement of foreign policy objectives.

For many countries the primary value of their bilateral FTAs is to obtain secure access to the US or the North American market, since these agreements turn their unilateral preferences into contractual obligations. By “locking in” open access to markets, FTAs help to considerably reduce uncertainty about the future course of trade and regulatory policies and thus facilitate business planning and investment. For developing countries, this benefit may be a key to the success of their investment-led development strategies.

For small economies, particularly those in the Caribbean and Central America, the stakes are even greater. For them, the issue is not whether to integrate with their hemispheric trading partners, but how to do so. Given their size, heavy reliance on the production and trade of a single commodity or service, underdeveloped physical infrastructure, and limited human and technological resources, these countries cannot afford to isolate themselves from their major markets since they are unlikely on their own to reap sufficient economies of scale and scope to compete effectively in global markets. The challenge for these countries is threefold: encouraging growth in trade and inward investment from their hemispheric trading partners; restructuring their economies to diversify the mix of production and expand employment opportunities; and managing the political backlash that inevitably will be provoked by the substantial adjustment burdens required to implement obligations under free trade agreements.

Bilateral trade agreements with developed economies are viewed by developing Latin American and Caribbean countries as providing an important venue

for increased and stable access to large markets, as well as instruments for positive signaling to potential foreign investors. These agreements are also used as development tools, to push forward programs of domestic policy reform and to strengthen national institutions.

Although these same objectives can be achieved through negotiating a trade agreement at the multilateral level, movement in Geneva has been much slower. Prospects for concluding the Doha Development Round are very uncertain. In terms of perceived benefit for effort, the bilateral option appears quite attractive to many policy-makers who need to finalize a "trade deal" and show concrete results while in office.

The objectives for developed economies to engage in bilateral FTAs in a North–South context are clearly different from the objectives of their developing partners. More developed-country governments look to trade agreements as first and foremost a foreign policy tool, helpful in solidifying political, security or strategic objectives. FTAs are perceived as one of the most effective instruments for creating political allies through binding economic ties. Additionally, the provisions of FTAs allow for the developed-country partner to participate in institution-strengthening along the lines that it perceives to be most useful. Having trading partners conduct trade relations according to the rule of law is a useful precedent for enforcing the rule of law in other areas as well.

In South–South FTAs, trade agreements appear to be used much more as vehicles to strengthen political processes or to weaken historic tensions. They may also be used as leverage to increase bargaining power vis-à-vis third countries on the multilateral arena.

Economic effects of FTAs in the Western Hemisphere?

What have been some of the economic effects of FTAs in the Western Hemisphere? Have these been positive and beneficial for members? Evidence for many agreements is mixed or still inconclusive. However, some general statements can be made, particularly about the NAFTA-type FTAs.

Faster and deeper liberalization for goods and services

FTAs have succeeded in achieving greater market access for the following reasons: tariff phase-out programs are based on quick, automatic and nearly universal schedules; the base rate for liberalization coincides with MFN applied rates for nearly all FTAs; most agreements carry out liberalization over ten years; and the scope of liberalization is nearly universal, as contrasted with that of the various multilateral trading rounds under the WTO.

Positive effects on rule-making

Recent FTAs have had far-reaching effects on rule-making in trade-related areas behind the border such as services, investment, competition policy, government

procurement, and intellectual property rights, going beyond the WTO Agreements. They have also brought about a modest amount of mutual recognition for trade in goods and professional services, and regulatory harmonization for services.

"Locking in" reforms

The robust dispute settlement mechanisms included in FTAs allow these agreements to be used as commitment mechanisms for institutional strengthening and for ensuring that reforms are not reversed by future governments.

Reducing domestic price distortions

Domestic reforms undertaken as result of FTAs have brought in more competition and reduced domestic price distortions. This happened, for example, as the Dominican Republic moved to reduce tariffs because of the FTA with Central America.

Inspiring behavioral changes

Transparency disciplines in recent FTAs have reduced the scope for rent-seeking in the private and public sector. They have also inspired behavioral changes over time in the functioning of political economy processes and in government–private sector interaction.

Are FTAs the best trade strategy for Latin America and the Caribbean?

Many have recently argued that FTAs are easier to realize, easier to defend at home, and more flexible than global or broad regional trade agreements. But are they the best trade strategy for Latin America and the Caribbean? Some considerations, as outlined below, may throw some sobering light on the pursuit of FTAs, although these are unlikely to dampen the enthusiasm of policy-makers to conclude them.

- Regional deals require a great amount of additional negotiating capacity, which is not always available, especially in Latin America and the Caribbean. On the other hand, they provide valuable experience for developing country negotiators and policy-makers, particularly where most of the issues are overlapping issues.
- Regional agreements may weaken the bargaining power of developing nations in subsequent trade negotiations, particularly at the WTO level.
- Improved market access to developed markets, especially as concerns agricultural products and the temporary movement of workers, is very difficult to achieve in FTAs, given the weak bargaining power that most developing countries have when dealing individually with economic superpowers.

- The proliferation of FTAs, with the US as the hub, requires Congress to vote more often on trade issues, which may generate a "liberalization fatigue."
- The more FTAs that are negotiated without positive short-run economic effects, the more difficult it will be subsequently to justify such agreements.
- The complexity of recent FTAs makes them extremely challenging to implement and administer, requiring considerable institutional sophistication as well as human capital. Trade deals also become more complex, because the different parts of the political spectrum and interest groups may add conditions as a price for their support (labor and environment on the one side, financial actors and IPR advocates on the other).
- Provisions on intellectual property rights contained in North–South FTAs are often more stringent than those the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). For Latin American and Caribbean countries this may mean the loss of some policy space (for example, in addressing public health problems).
- On the other hand, governments in developing countries may use the FTAs as an important tool to justify difficult policy changes that may be in the best interest of their economies and that they otherwise could not have managed to push forward.
- FTAs may boost intra-regional trade, but they may also reduce incentives to further liberalize at the multilateral level. Developing countries that enjoy preferential access to developed markets are likely to resist further most-favoured-nation (MFN) tariff reductions.

Fitting the many FTAs into broader hemispheric integration

With the ever-growing web of bilateral and plurilateral FTAs in the hemisphere, the future of trade relations is becoming increasingly complex. How can these individual agreements be fit into some broader, coherent framework, and how could the coexistence of the FTAA and other trade agreements be reconciled? Currently there are more than forty trade agreements in the Western Hemisphere, apart from the ones under negotiation. Making this complex set of trade agreements compatible presents a real challenge.

Three possible scenarios can be envisaged, assuming that at one point the FTAA negotiations again move forward (Zabludovsky, 2004). The possible scenarios are:

- An ever growing spider web of RTAs
- An à la carte two-tiered approach along lines of Miami Ministerial Declaration
- A hemisphere-wide FTAA as a docking station for basic market access.

Growing spider web of RTAs

Under this scenario the United States would continue to negotiate bilateral or subregional agreements, and to reinforce its position as the center of a hub-and-spoke arrangement in the hemisphere. This would happen if the US decides to negotiate with the Caribbean in the near future, as well as to finalize the FTA already underway with Ecuador, and to open negotiations for an FTA with the smaller MERCOSUR members, Paraguay and Uruguay. However, under this scenario, the Latin American and Caribbean partners of the US will not be able to accumulate value added to satisfy rules of origin in their exports to the biggest market in the world. If the FTAs currently under negotiation are successfully concluded, then the result of the US bilateral approach to trade relations in the hemisphere will be to unite all the Pacific Coast countries of North, Central, and South America together in free trade with the United States, if not among themselves.

The same would apply to agreements negotiated by Brazil with countries in the Southern Hemisphere, though on a smaller scale. Brazil's expansion of MERCOSUR constitutes a political and economic alternative to the US expansion of the NAFTA-type FTAs with like-minded partners. At present these two initiatives are on a collision course. However, each contributes to increasing the number of regional agreements in the hemisphere and thus making the flow of commercial relations more complex for traders and investors.

À la carte two-tiered approach

Under this scenario there would be a common set of rights and obligations (mandated from the Miami Ministerial Declaration 2003), with countries undertaking different levels of commitment. Two sets of rights and obligations would coexist: a common set shared by all countries; and plurilateral arrangements for participants willing to assume additional, deeper commitments. Given the history of the past two years and the strong polarization in the hemisphere presently surrounding the question of trade and economic integration, this scenario is looking increasingly unlikely.

Docking station

Under this scenario the FTAA negotiations would be revived but in a much more modest form than before. An ultimate hemispheric FTAA agreement would constitute a form of "docking station" and contain disciplines for trade in goods only, while leaving the rest of the agenda open for bilateral agreements. The docking station would be a free trade zone (FTZ) for goods, based on accumulation of origin, and would include a dispute settlement mechanism and institutional arrangements. Countries of the hemisphere would progressively link themselves to the docking station through bilateral negotiations. Other disciplines such as investment, services, Generalized Preferences and intellectual

property protection would be part of the bilateral relations between members of the FTAA but would not be included in it.

Three main consequences can be imagined as the result of these scenarios:

1 A future FTAA would have its own set of negotiated rules, tariffs, and requirements while the exporter decides on a case-by-case (à la carte) whether to opt for FTAA treatment or treatment under another subregional agreement;
2 A future FTAA would incorporate pre-existing agreements on tariffs and rules of origin for goods, becoming the only valid legal agreement governing hemispheric trade, with the other agreements continuing in effect but retaining essentially their political character;
3 A future FTAA would be a voluntary agreement that does not step in to regulate tariffs, rules of origin or technical requirements among countries that already have other trade agreements in force.

Why then bother with the FTAA?

The short answer to this question is that an FTAA would yield both economic and foreign policy benefits. First, the FTAA would have beneficial effects on the conduct of overall economic policy in, and economic relations among, the participating countries. Second, the FTAA initiative covers the one big gap in the free trade matrix of the Western Hemisphere, linking the major economies of North and South America, whose bilateral trade, as projected by gravity models, could expand two- or three-fold in response to FTA-type reforms. At the same time, the hemisphere-wide FTA would help harmonize over time the separate free trade regimes that have been negotiated among regional trading partners. Left as it is, the current situation is leading rapidly to the development and legal consolidation of a hub-and-spoke arrangement, in which the largest market – the US market – serves as the hub, with the other countries being the spokes. The main spokes still missing from this wheel are the Caribbean countries and the MERCOSUR members, but all of the other spokes will soon be in place.

Third, and perhaps most importantly, the FTAA should be the economic engine that drives hemispheric cooperation on more than twenty initiatives undertaken by leaders at the Summit of the Americas involving a number of political, socio-economic, and cultural issues (e.g., promoting education, strengthening the rule of law, protecting the rights of indigenous peoples, among others).

Conclusion

The policy of concluding individual FTAs in lieu of a hemispheric agreement has the merit of continuing to further the process of trade liberalization within the hemisphere, albeit on a piecemeal basis. However, it has the defect of developing into a hub-and-spoke structure in which the United States has bilateral

free trade with many countries, but this freedom of movement for goods and services cannot be generalized as between the Latin American (and possibly in the future, Caribbean) signatories. Likewise, Brazil's creation of a South American free trade space might stimulate trade among South America, but omits other subregions of the hemisphere (the Caribbean, Central America, North America). Neither approach serves to stimulate intra-hemispheric trade or investment on the whole, instead continuing to fragment the various trading partners and regions within the Americas.

The proliferation of bilateral economic integration agreements as a trade strategy in the hemisphere may also serve to complicate trading relationships. Rules of origin almost always differ among the agreements. Exporters find themselves searching for the proper country from which to export goods in order to ship from a country that has preferential relations with the destination country. Having a single preferential agreement in the hemisphere to cover trade flows and trade relations would certainly be more desirable than the proliferation of the many and varied agreements that now exist.

Fostering economic development is the most important objective of most Latin American and Caribbean countries. They have been anxious to conclude bilateral FTAs with the United States because of the access they would gain to the largest hemispheric market. However, for most countries in the hemisphere, their ultimate ambition remains the creation not of a bilateral market but of a hemispheric one, that promotes South–South trade and investment flows as well as North–South flows. They well realize that the main beneficiaries of an FTAA would be the countries of Latin America and the Caribbean, primarily because they would achieve free trade at last with each other by removing their own barriers (often quite substantial) to intra-hemispheric trade.

The communiqué of the recent Summit of the Americas in Mar del Plata shows that most countries in the Americas wish another opportunity to move forward together to create an arrangement that would enhance their trade both with the United States as well as with each other. However, the growing ideological rift that is opening in Latin America between those countries embracing trade liberalization and globalization and those that would appear to be turning inwards towards populism, trade with "social overtones," and greater economic self-reliance may well impede the resumption of the FTAA negotiations in the near future.

At some point in the twenty-first century the FTAA may become a reality, but it will not do so without the necessary political will and leadership. The worthy vision of a free trade area encompassing all thirty-four of the democratic countries in the Western Hemisphere deserves to be reconsidered before the web of smaller subregional agreements becomes too entangled and this historic opportunity slips away. The next positive alignment of like-minded elected governments in the hemisphere will be key to finally bringing this initiative to a successful conclusion.

Notes

1 The author is Acting Director of the Department of Trade, Tourism and Competitiveness at the Organization of American States (OAS). The views expressed in this paper are those of the author alone and not of the OAS nor any of its member states. The author would like to recognize and thank Paul Fisher, Maryse Robert, Theresa Wetter and Cesar Parga for their valuable comments on the paper and for the insights they provided on the issues raised. The author can be contacted at sstephenson@oas.org.
2 See explanation of the ALBA on the official website (www.alternativebolivariana.org).
3 The XXX MERCOSUR Summit will take place on 21–22 July, 2006, in Cordoba, Argentina. This will be the first official meeting at which Venezuela will be present as a full MERCOSUR member. In addition, heads of state of the five Associate Members will be present at the meeting: Bolivia, Chile, Colombia, Ecuador and Peru. President Fidel Castro of Cuba is also expected to attend as an invited guest. See Europa Press and BBC News of 19 July 2006.
4 In particular, tensions have recently been heightened between Argentina and Brazil and the smaller members Paraguay and Uruguay, who feel that they have not been receiving sufficient economic benefits from the regional grouping. The recent creation of the development fund is designed in large part to placate these perceptions. See El Pais of 20 July 2006.
5 See article “CARICOM may abandon FTAA” from 3 July 2006.
6 News release from the RNM on 12 April 2006: “CARICOM Trade Ministers, Portman Agree on Council to Advance Trade Relations.”
7 A detailed analysis of this new template for FTAs is found in a comparative study of the Chile–US and the CAFTA-DR-US Free Trade Agreements that was carried out by the three institutions of the Tripartite Committee (IDB, ECLAC, OAS) and can be found at www.sice.oas.org/TPCStudies/Default.htm

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4 The FTAA–WTO divide

The political economy of low ambition

Mário A. Marconini[1]

Introduction

World trade is doing unusually well halfway through the first decade of the new millennium, but trade agreements are faltering. In the Americas, the greatest ever initiative for the region has gone into an induced coma after more than ten years of negotiations. In Geneva, trading partners manage to move very slowly, in an exercise which attempts to reconcile the consistent lowering of ambitions with the need to spread the blame equally amongst those involved. Around the world, the question to ask is, does it make sense to devote so much energy to so many agreements? Is free trade being served or is something else the endgame? Maybe trade does not *need* agreements any more and can take the reins of its own destiny. Countries certainly continue to have great difficulty selling trade agreements internally, at least insofar as they are perceived to meddle too much with domestic policy. Many countries still go through the motions, but often for reasons other than trade itself.

In what follows, a panorama of the current state of affairs in world trade is attempted as seen from a Brazilian viewpoint. In addition to sections on relevant facts, perceptions, and consequences, one section is fully devoted to Brazil as a "factor" in the evolving trading regime. The concluding section looks at the way forward.

The facts: the yo-yo period

The timespan between the 9/11 aftermath and the current trade policy juncture has had its high and low points, in a fairly random web of small achievements, big failures and even bigger near-misses.[2] The trading system is alive, but the dynamism of trade itself has little to do with the proliferation of trade agreements. Trade may be doing well for its own reasons: bullish world markets, major new players on the block, reforms kicking in, and an increasingly aggressive business environment around the world. The agreements may sometimes even confuse things. Trade policy oscillates, and commitment to free markets is not always there if it requires making significant concessions.

The events of 9/11 in 2001 had a determining effect on the trade universe.

The renewed fervor with which the US promoted the Doha Ministerial Conference and fought for the launch of a new round in the aftermath of the terror was perhaps the single most important factor moving the system forward after a decade of little concerted effort or attention. That was an achievement, a high point. Shortly after that, however, the USTR would be announcing a number of protectionist measures, ranging from the 2002 Farm Bill to safeguards on imported steel. The approval of the Trade Promotion Authority (TPA) would itself be the result of an array of anti-trade concessions.[3] The year 2002 would be a mixed year for trade policy.

The year 2003 was laden with important dates. September was the month of the WTO Cancun Ministerial Conference, while November was to hold the most important ministerial meeting in the US since the Seattle fiasco in 1999 – the FTAA's eighth since 1994, and once again in Miami, where the all-encompassing "Summit of the Americas" was launched. Both meetings would make things more complicated moving forward. Cancun was a fully-fledged collapse, while Miami resulted in a sophisticated, complex and ultimately tortuous text that avoided anti-globalization street rowdiness and pro-trade commitments at the same time.

Cancun took place against the backdrop of a hazardous phenomenon: a transatlantic alliance in defense of agricultural subsidies, as agreed between the US and the EU a couple of months before the meeting.[4] The US therefore no longer championed the cause of free agricultural trade and moved dangerously close to accepting some of Europe's most archaic protectionism. The reaction would coalesce around a new grouping of countries – the then-called G21 which has since stabilized at twenty-one members, always led by Brazil. The group was a major opposition force to agricultural protection and managed to get the "majors" somehow back to the negotiating table – as opposed to permitting them to get away with such disdain for the multilateral trading system. Beyond the internal contradictions and mistakes then, now and in the future, the G20 has been playing an important role ever since and in retrospect should now be considered a high point in Cancun – despite the havoc and despair there.

In the Americas, the Miami Ministerial Conference was important because neither side – neither of the co-chairing countries, Brazil or the US – really wanted an agreement at that stage nor fancied taking any blame for ruining it. The final document had "dual tracks", various levels of rules, possible commitments and acceptable rhythms, in an ensemble aimed at silencing Brazil and its allies while pretending to advance on free trade. Canada, Chile, and Mexico were not happy at all with the co-Chairs, particularly as these two arrived at the meeting with an already agreed but highly objectionable ministerial text. Neither of the co-Chairs budged, and Miami had a text despite overall discomfort on the part of most participating countries. Time would tell, indeed, and the FTAA has never found a single track to ride on since that time. Power, ideology, horse-trading, and political expediency all have a piece of the story – as usual.

The year of 2004 had the distinction of holding the end dates to a number of important negotiating processes. Both the Doha Round and the FTAA were

supposed to finish by 31 December 2004. For Brazil, a main protagonist in both contexts, another negotiation was also in the making, had the same final date and could indeed influence the country's overall outlook on trade depending on its outcome: the MERCOSUR–European Union talks, aimed at an interregional transatlantic (South Atlantic) association agreement. Early in the year it was already evident that neither Doha nor the FTAA could comply with the deadline. In the case of the interregional talks, however, hope gave way to an effective shot at an understanding which, ultimately, resulted in nothing more than a prominent near-miss for both parties. Trade-offs involving financial services, beef quotas, automotive phasing-out schedules, and appellations of origin proved insufficient by October of that year to keep the negotiations alive: they were thrown out then and have remained that way ever since.[5]

It was in the middle of 2004, in July, that negotiators in Geneva were able to agree to a text that restored a minimum level of balance and perspective in the Doha negotiations. More than an introduction and four annexes, the "July Package" gave the negotiations a new momentum and a work plan which could, if well adhered to, provide a solid basis for success in the upcoming Hong Kong Ministerial Conference in the following year. The most significant commitment in the text was the first-ever agreement to abolish all forms of agricultural export subsidies, alongside a breakthrough in cotton trade – one of the sticking points at the Cancun meeting and beyond. Some dates were agreed, including a deferred deadline for the end of the negotiations (no longer 31 December 2004) and a date for Hong Kong.

A full year later, July 2005 was supposed to produce a text from the Chairman of the Doha Negotiations on the so-called "first approximations" to the various dossiers then under negotiation in Geneva. It never did, and finger-pointing and posturing followed as expected. The results, however, had not been as bad as the press and those rooting for a new debacle in the multilateral sphere tended to think. The fact was that there were enough elements for an agreement to take place at the Ministerial Conference in Hong Kong, that coming December. In any case, Hong Kong was not supposed to be the end of the Doha Round but rather its last major boost.

CAFTA was approved on the same day that ambassadors had to wrap up their July 2005 deliberations in Geneva. CAFTA approval, therefore, had no chance of influencing the Doha talks because it came perhaps too late. Even though CAFTA was the "bare minimum necessary" for the world to continue to believe that the US could and wanted to lead trade matters (as opposed to hiding behind its own shadow), it should not be confused with the long-sought salvation of the system. The Doha Round had a difficult dynamic of its own, and the influence of a CAFTA or any other external element should be seen for what it was: just another external element among many.

The effect of the defeat of the European Union's proposed new constitution via referenda in both France and the Netherlands in the first semester of 2005 had in fact been a cold shower for many of the EU's international pretensions, including the Doha Round. This may explain in some measure the difficulties in

Geneva in July of that year, not to mention the sluggish pace of the MERCOSUR–EU talks since October 2004. Given that Jacques Chirac, France's President, had staked a personal position on approving the twenty-five-state Treaty Establishing the EU Constitution, and that France has always been behind any European hesitation on agricultural reform, the writing was on the wall for those willing to see it.

There was agreement at the end of the Hong Kong Ministerial Conference in December 2005. After a week of days and nights of negotiation, a new draft text of a Ministerial Declaration was distributed on Sunday at 4pm HK, containing a few surprises. For those who had unrealistic expectations regarding Hong Kong, the text was clearly insufficient. For those who, having seen the difficulties both at and before Hong Kong, expected a fiasco or something close to it, the text contained enough to keep the system and the negotiations alive. The date for the end of agricultural export subsidies was agreed as 2013, and some commitments on cotton were made. Not much more than that, yet Hong Kong was instrumental in keeping a minimum momentum going. Missing the 30 April 2006 deadline for the modalities in agriculture and non-agricultural negotiations would, however, come as a major blow to the negotiations.

In the hemisphere, things have quickly evolved to a very complex situation. Any reference to an FTAA has indeed been rare, but Washington has moved very aggressively toward bilateral agreements with Latin American partners. The first semester of 2006 has seen the conclusion of the Peruvian and Colombian negotiations with the US, while MERCOSUR continues to go through disputes between Brazil and Argentina, complaints from Uruguay and Paraguay, and a heavy but inconsequential external agenda, including the welcoming of Hugo Chavez's Venezuela into the block as a "member in the process of a transition". Uruguay has gone as far as to propose direct negotiations with the US even if it has to abandon the South American block to do it. Another emerging sticking point is the fact that MERCOSUR has an agreement with the Andean Community – a compilation of sixty-seven phasing-out schedules – which is blatantly less ambitious than Peru's or Colombia's just agreed pacts with the US.

The perceptions: the aimless wanderer

As a system, the trading regime seems to be wandering aimlessly, in search of an agenda or a reason to hold itself together. Bilateral and other agreements proliferate and do give the impression of dynamism and progress toward free trade. The picture is, however, mixed at best. For example, while NAFTA-type agreements do lock in place open regulatory regimes and provide for some tariff phasing-out, it is not clear how much additional market opening it provides in the US market in the absence of effective commitments on, say, antidumping or agriculture. Industrial products in the US are already subjected to a very low tariff average. Additional liberalization is clearly not often on the cards, lest it would not pass in the US Congress – as is clearly illustrated by the one-vote

majority that made the CAFTA-DR Agreement a reality after some considerable internal horse-trading between the Executive, the Congress, and some specific constituencies within the country.

Brazil has also been particularly keen on aimless wandering. Via MERCOSUR, it has struck deals with India and the South African Customs Union (SACU) which amount to very little effective trade. With the Andean Community it has agreed to long phasing-out schedules and avoided talking about anything beyond goods. MERCOSUR has been constantly negotiating with distant and unusual partners such as Morocco, Egypt, and the Gulf Cooperation Council, but always with a view to very modest agreements that hardly go beyond mere fixed preferences for a limited number of agreed goods. Alongside the US, therefore, Brazil, the co-Chair of the FTAA process, avoids hemispheric talk and shoots in all directions – albeit with a different emphasis. An agreement involving the two co-Chairs which could indeed produce real liberalization and market opening by tackling at the same time US agriculture and trade rules alongside Brazilian industry and services seems, however, to be out of the question.[6]

The wandering is all the more aimless, the more the trading system is headless. Unlike the fifty years that preceded the advent of the WTO, there is no strong leadership in global trade matters nowadays. Unlike the eight rounds of GATT negotiations that preceded the coming into force of the WTO, the enlightened presence of the US as the mover and shaker of the multilateral trading system can no longer be taken for granted. The traditional US drive to push for global liberalization whenever a few important elements such as a high dollar, a burgeoning trade deficit or the expansion of Europe were in place has been replaced by "competitive liberalizations"[7] at best and "spaghetti bowls"[8] at worst.

Whatever the term used, the move away from multilateralism, albeit very pragmatic for those that have bargaining power and do not want to make concessions, implies more discrimination and the rule of the stronger as opposed to non-discrimination and a balance of rights and obligations in world trade. It may not be a coincidence that the clear emphasis on regionalism and bilateralism where might tends to make right comes precisely when real concessions need to be made by the majors on their most antiquated, sheltered, and vocal sectors: agriculture and all the business (industry and services) that moves with it alongside textiles, shoes, and a few other assorted nineteenth-century industries.

Europe has traditionally reacted more than acted on multilateral matters, a reflection of the strength of its own internal agenda which is a demanding trade-off between deepening and expanding its integration process. It has been successful on both accounts, although the upper limits have become clearer since the aforementioned referenda and consequent rejection of its constitutional plans. Europe's commitment to the multilateral system is secondary at best, given the complexity and urgency of its internal process. One gets the impression that Europe, in much the same way as large countries, spends most of its time gazing at its own belly button. The only novelty in that context in the last

few years with the entry of ten new member states is that the button may have moved from its "original" place – away from somewhere between Paris and Berlin to somewhere between, perhaps, Lyon and Warsaw (more to the South and to the East). Europe cannot lead multilateral negotiations in Geneva. It can be a major and crucial player, but ultimately it will act and react according to cards that are expected to be dealt by the US.

There are, of course, the new "leaders" – the pack led by Brazil that crucially brings together the likes of China, India and South Africa, among others. The group has proved to be powerful, to influence matters at delicate moments, to contribute to moving things forward. Can it lead the system, however? Clearly not. The G20 can be expected to lead the "opposition" – i.e., the side of those that oppose the lack of commitment with the multilateral system and, admittedly, with agricultural liberalization. In fact, it was created indeed for agricultural reasons and has never been able to delve into other matters and show a common face. Even when it has tried, it has done so very discreetly, in a way that revealed the group's own second thoughts regarding too much ambition or the difficulties involved in achieving it jointly.

Brazil is not keen on joining India on services because its interests are quite different in that regard. India is not keen on joining China on NAMA because its interests are also quite different in that regard. Even on agriculture, Brazil has to be careful not to reduce excessively its own ambitions in the round, were it to accept all of India's and China's agricultural hesitations. In Hong Kong, when Brazil led a coalition of 110 countries – the G110 – which brought together the G20 and the G90 (a hodge-podge of developing countries from all corners of the "South"), its own agricultural lobby was furious about the specter of additional "fudging" on liberalization.[9] For matters internal to the G20 or for the continued importance of the world's traditional trading "majors" – the US and the EU – new leaders should not be expected to lead the system as such. The influence of the G20 members on regionalism and bilateralism, for example, is topical, localized and specific to each agreement – nothing like the sort of influence that the US or the EU may have on the matter as they lead the world by example.

The consequences: riding on a bad excuse

The lowering of ambitions at the WTO – where meaningful concessions could be made on agriculture, textiles, and other sensitive matters for the majors – coupled with a rush to bilaterals and other partial agreements that successfully keep those matters off the negotiating table – give great ammunition to skeptics and the anti-globalization crowd. The message is that "we, the majors, only like liberalization where it opens other markets and keeps ours more or less in the same overall place, thus ensuring that our politically sore and delicate issues stay away from Congresses and Parliaments despite the cost to consumers and tax-payers". Regionalism and bilateralism put forth greater risks than just creating bowls of spaghetti: they also function as a convenient way to avoid hard choices and bold market openings on the part of those powerful enough to do so.

Agreements with Central America or Jordan may indeed favor a few specific export items from those countries, but do not provide for meaningful liberalization of sectors where the biggest distortions in the world economy reside. It is indeed good for the US and the EU – the owners of the heavier sticks – and maybe even for those countries if they manage to include one or two crucial items in the deal. It is definitely not good for the world economy insofar as it avoids a true restructuring of economic activity according to competitive or comparative advantages – whether per textbooks or observable market realities. In other words, by going regional or bilateral the majors definitely get more market access, but real trade liberalization is shortchanged since those agreements hardly touch on the greatest distortions in the world markets. Only multilateral liberalization can provide for a truly global restructuring of the world economy. Regional agreements such as the FTAA could tackle some of that by addressing at least tariffs and other market access barriers in agriculture. Unfortunately, not even that has been possible, which explains in large measure why the FTAA has been abandoned as a bilateral, Brazil–US matter.

When countries that consider themselves unwilling or unable to undertake liberalization see the current trade "drama" as it develops, they have it easy: they can easily say that they are not going to play ball because the majors are not serious and do not want to open up their markets in areas of crucial interest to them. By saying, thinking, and acting upon such a statement, these countries will feel more than free to pursue their own "trade" agendas, to devise their own "independent" trade policy, and have the often illusionary impression that they have regained their otherwise lost or highly threatened "policy space". They will tell the world that free trade is a hoax and that they have better goodies to offer than just market opening and unemployment. They will make use of trade as an instrument amongst many for the pursuit of their most diversified interests – often, in fact, unrelated to trade itself. This is where ideologues meet free traders, legitimately blaming the leaders' sluggishness for their lack of commitment, when in fact they would not move anyway. Any coincidences with the position taken by the Lula administration in the last few years are, indeed, intentional.

Trade agreements should not be seen as a panacea for all the ills of a country's economic development. They are merely a tool in that regard, but may be a very good one at that. For "unconvinced" countries, trade agreements may be an inducer of integration with the world and reforms at home, and result therefore in significant improvements in domestic competitiveness and the regulatory regime. This is why the demonstration effect alongside an active stance on the part of the majors is a crucial element in global trade policy. Countries that are "left to themselves", so to speak, may not be naturally inclined to open up their own economies, revamp their own regulation or otherwise do the difficult part of integrating themselves into the world in the absence of inducements such as trade agreements. It is a sad state of affairs, but it is real.

The fact is that countries that do well in the trading system, in trading per se, are countries that have effectively integrated themselves into the world economy

– whether by concluding trade agreements or simply by doing their homework well. Southeast Asia never needed trade agreements to successfully integrate itself into the world economy. It began to open up its economy earlier than, say, Latin America. It moved forward on domestic reforms, it sought markets overseas, it overhauled and revamped practices to adapt them to the realities of the world market, and has, effectively, "joined the club" – admittedly with problems, but better placed to resolve them. In Latin America, countries have for long transferred their own responsibilities onto trade agreements. "Formal" but not "effective" integration in the region has gone through different generations already.

In the 1960s and 1970s, integration was to be an extension of national import substitution policies to the regional level but failed precisely because countries could not even think beyond their own markets when substituting imports. In the 1980s things began to change, but nothing more than fixed preferences were negotiated and intra-regional trade remained small. In the 1990s, markets were opened and much improved, including impressive hikes in productivity levels and FDI inflows. MERCOSUR, for example, had its significant pro-trade moments, and so did the Andean Community and other regional pacts. Some of that would stall, come the new millennium and a concerted opposition to Washington Consensus tenets in the region. There has not been a full reversal in that respect, but there has been indeed sufficient confusion in national debates and policies so as to turn the clock back on some matters – trade liberalization, for one. This, of course, did not apply to all countries in the region. Brazil has, however, been a prime example of that trend.

The Brazil factor: the internal trade-off

Tom Jobim, Bossa Nova's creator, has said it himself: Brazil is not for amateurs. The country is indeed big and complex, and that is how it looks at its trade and policy as well.[10] There is some good and some bad news in that regard.

There is no denying that the trade numbers are good. A surplus of close to US$45 billion in 2006 for a country that had a deficit of US$7 billion in 1997, in what constitutes therefore a reversal of over US$50 billion in its trade balance in only eight years, is indeed good news. The current account tells an even more impressive story, having gone from a deficit of US$24 billion in 2000 to a surplus of over US$14 billion in 2005 – a volta-face of roughly US$40 billion in just five years.

In terms of overall trade flows, Brazil is finally approaching the US$200 billion mark (US$192 billion in 2005), in what has accounted for a 78 percent hike since 2002 and a full doubling in the last ten years. The trade flow as a part of the country's GDP – the market openness index – has gone from 11 percent in 1990 to 24 percent in 2005 (14 percent in 1995, 18 percent in 2000). Brazil cannot rival Mexico (53 percent) or China (50 percent) with these numbers, but the increasing importance of trade in the Brazilian economy is a most welcome piece of news, regardless. Trade is also very diversified and "balanced" with all

parts of the world, with Nafta accounting for 22 percent, the EU for 23 percent, Latin America for 19 percent (of which MERCOSUR accounts for 10 percent), Asia for 18 percent, and Africa for 7 percent. Trade with "non-traditional" partners has also loomed large on the horizon lately, having grown 200 percent with Africa in the last five years and 350 percent in the last ten.

Another piece of good news is the transformation that has taken place "on the ground". Much of what is seen now can be attributed to the market opening, the modernization and restructuring that the economy went through in the 1990s. Studies have forcefully shown[11] that Brazil had exceptional Total Factor Productivity (TFP) gains in the post-opening period (1996–2000) when it reached 2.7 percent a year, well above Mexican gains (1.2 percent) during both of its liberalization periods (pre- and post-Nafta) and commensurate with Taiwan (3.2 percent) and South Korea (3.1 percent) during theirs. In the second half of the 1990s, the sectors that had the greatest productivity gains in Brazil were those fully exposed to trade – the tradable sectors, whether within MERCOSUR, the region or the world.

The fact that Brazil has become a leader on a number of trade fronts is also good news. At the WTO, the G20 involvement alongside a very proactive approach to dispute settlement panels where the country has taken on the US on cotton and the EU on sugar, in addition to a number of other less conspicuous cases, surely adds to Brazil's outright protagonist role within the organization. Regionally, Brazil has led MERCOSUR both internally and externally, having managed many a crisis and having engaged the block on a full host of negotiations with partners around the world. In addition to association agreements with Chile, Bolivia, and the Andean countries, Brazil spearheaded the creation of the South American Community of Nations at the end of 2004. Outside the region, Brazil launched a trilateral initiative with India and South Africa (IBSA) in 2003 which served as a complement to the above mentioned MERCOSUR agreements with those countries (SACU in the case of South Africa). The good news here is that Brazil is somehow in touch with partners around the world.

There is, however, bad news. First of all, the fact remains that Brazil, despite all the improvements and the bullish markets, still accounts for only 1 percent of world trade – whether exports or imports. These numbers were much better in another era, the 1950s, when Brazilian exports accounted for 2.4 percent and imports 1.7 percent of world totals. These numbers are currently similar for services trade as well. Brazilian investment overseas also sits at around 1 percent of the world total. Brazil is one of the greatest recipients of FDI, vying with Mexico for second place in the developing world, but its own initiatives abroad are close to insignificant. The country is clearly going through a 1 percent "syndrome" all around.

Trade policy has been a disappointment as well. It is true that the numbers are bullish, but they are hardly any better than world trends. The fact is that world markets have been bullish and buying. Brazil has benefited accordingly, but so have its main competitors and, in some cases, more so than Brazil. The government has been as market-seeking as it can, and that is laudable. Exporting pol-

icies are therefore moving forward and the system is constantly under scrutiny for revision. Importing policies, however, are few and far between. There has been no overall assessment of what to do with imports, of how to look at trade as a two-way proposition. In essence, trade policy in Brazil has not taken the additional step from seeking markets to seeking efficiency as such. It has been lopsided in that regard. This is, of course, a political issue. Talking about trade as a flow and not just as everybody else's market opening normally takes political courage.

There has been a lot of criticism concerning the perceived encroachment of geopolitics into the trade policy realm. The private sector, the main interested party in trade matters, has been highly critical of the government's approach to trade agreements. Not only is there a lingering impression that the government is slow on agreements with Brazil's main trading partners that together account for half of the country's trade – the US and the EU – but there is also strong evidence that the government is willing to pay "trading prices" for geopolitical matters of its interest. Thus, agreements with the likes of India or South Africa, despite not making much sense for a country that fears competition from FTAA partners, fulfill other non-trade objectives – the most prominent of which is, of course, the search for a seat at the United Nations Security Council. The private sector, once again, does not find it amusing whatsoever to see its markets being exchanged for distant geopolitical aims – particularly when they are scarcely consulted about such agreements or such objectives.[12] With China, the most delicate case in the whole world, Brazil has pretended to have a "strategic alliance" despite various Chinese signs to the contrary.[13]

The most negative aspect to reckon with in Brazil's trade universe is the so-called "Brazil Cost" – a hodge-podge of doing-business and doing-trade obstacles that plague the country's overall trade and investment regime. According to the World Bank,[14] there are twenty-seven dates a year that a normal Brazilian citizen or entrepreneur has to remember for tax reasons. Doing taxes may take up to 2,600 hours a year – another world record, against eighty-seven hours in Norway. There are more than fifteen procedures in order to open up a firm in Brazil, while in Australia one can do it almost instantly, by the Internet. Even more serious is the infrastructure deficit. Expert estimates put the minimal investment in infrastructure required to bring it to a global average state of affairs at at least US$12 billion a year.[15] The country has been getting only half of that because the regulatory environment has not yet been clearly defined after a few years of back-and-forth oscillation between Congress and the Administration.[16]

A very common perception in the country is that successive governments have delivered on *macro*economics but fallen disastrously short of addressing *micro*economics. The necessary regulatory overhaul and revamp has not taken place, nor have the main restructuring reforms of the pension, tax, and labor systems – all of which account for one of the highest burdens on trade and investment in the world. Brazil's tax burden is at Swedish levels. Brazil's infrastructure is far from Nordic standards, however. To top it all off, Brazil's interest rates have been consistently the highest in the world. In 2005–2006, the

appreciation of the Brazilian currency, the Real, vis-à-vis the US dollar has been the greatest in the world as well. Brazilian exports have borne the brunt of it. Entrepreneurs have yelled and screamed accordingly.

Brazil's trade is moving forward in the absence of trade agreements. In the last ten years, there has been no significant agreement whatsoever negotiated, ratified and applied that has effectively resulted in increased trade flows – with the possible exception of a Brazil–Mexico agreement on a number of automotive items which did indeed increase Brazil's related exports to Mexico in a short period of time.[17] Despite bullish markets and numbers, Brazil needs to continue on the path of increased integration with the world economy and may not yet have the conditions to do so due to a significant array of self-imposed barriers. A lot of homework is in order, including a reconsideration of trade policy, trade agreements, and, ultimately, trade liberalization. The problem is political, but it would be unfair to characterize those in opposition to further market opening as mere protectionists.

There may not be any entrepreneurial class in the world that would welcome further market openings in the presence of the conditions faced by Brazilian producers *in their own market*. The Brazilian private sector may be less averse to further liberalization than it is to the apparent perpetuation of the so-called "Brazil Cost". There is a consensus on what needs to be corrected and on the urgency of the matter. However, successive governments have failed to act, dangerously allowing the country to be overtaken by a number of important competitors in the world. Observers overseas should look for the internal trade-off when trying to understand Brazil's positions in international fora. Increasingly, Brazil's producers will link international initiatives with domestic commitments on the part of government. The average applied tariff for industrial products in Brazil is as low as 10.5 percent, with items such as chemicals and capital goods having tariffs close to zero in many cases. The problem is not there, but rather on how fast the government can deliver on a trade and investment regime that approaches a level playing field vis-à-vis a much less burdened outside world.

The quagmire: US meets Brazil

Luiz Inácio Lula da Silva's opposition to an FTAA had been an integral part of the four-time presidential candidate's government plans. Things would change significantly in the 2002 campaign when he would distance himself from a plebiscite on the FTAA sponsored by Brazil's main workers' union, CUT, and manage to transform his previous obstructionist stance into a conditional willingness to negotiate a hemispheric pact. From the look of Lula's first ministerial cabinet, an FTAA could not be ruled out altogether. After all, the Ministers of Finance, Development, Industry and Foreign Trade, and Agriculture were all in favor of moving forward. It could not, however, be "ruled in" either, since both the presidency and the Ministry of External Relations were staffed, at the highest levels, with personalities that had traditionally opposed the FTAA, in both the written and spoken media.[18]

The cards were dealt therefore for a true game to start. Effectively, there were two camps within the government on matters relating to trade in general and trade agreements in particular. The FTAA, naturally, continued to be the greatest challenge for the Brazilian body politic, and the principal theater for the tug-of-war that would prevail in the first couple of years of the Lula administration. A crucial definition would take place towards the end of 2003, in the run-up period to the Miami Ministerial Conference (November), when the President decided, after much bickering and public disagreement amongst his ministries, to attribute the leading role for trade negotiations to the Ministry of External Relations – thus not only bringing that ministry back to the center of trade negotiations but also giving it a highly prominent place in trade-policy-making *tout court*. One of the most prominent readings of the Presidential *diktat* at that stage, both within and outside Brazil, was that the government had opted for hardening its position in the FTAA negotiations. That perception would prove very accurate in a short while.

There is no doubt that some of the blame for the demise of the hemispheric negotiations lies on the back of Brazil and Lula. The ideology was there from the outset, and Brazil did force negotiators to tough decisions in the process. To say that the demise was exclusively Brazil's fault, however, is not only inaccurate but also oversimplistic. Despite the ideological cloud behind which Lula and his team hid, the fact is that Brazil had important, substantive demands in the negotiations which were unlikely to be satisfied. Had it simply hung on to demanding market openings in areas of its interest – primarily agriculture and antidumping – the US would have had great difficulties delivering. The Brazilian logic, after all, with Lula or before Lula, had been as follows: in order to concede on industrial products, services, investment, government procurement, and intellectual property, amongst other things, Brazil would have to see a "decent" package emerging out of the only aggressive items in its agenda – agriculture and antidumping. Only then would an equilibrium be possible that would allow the government to sell internally the idea that Brazil had "gained" something from the negotiations. After all, the US was already open to the world in industrial products and could not, therefore, offer any meaningful preferences in that realm to Brazil – or the rest of the hemisphere.

Lula and Lulism apart, the fact is that an FTAA for Brazil can only work in the presence of major agricultural concessions – of the sort that the US has clearly not been in a position to make. In other words, the problem has much to do with trade itself, and not just politics or ideology. There have not been enough "cookies" in the FTAA for Brazil to justify all the trouble it would have to go through internally.[19] To say that Brazil should do it because unilateral liberalization is good and Brazil needs it is indeed a tremendous understatement. So it is, however, when applied to US agricultural protectionism or its frequent recourse to antidumping measures. Of course free trade is good from an economy-wide perspective: the problem is how to muster enough support for it internally so as to placate hesitant, protectionist sectors. The FTAA may not have that edge for Brazil, and this is yet another reason why the WTO deliberations are so

important. Were the Doha negotiations to result in meaningful agricultural opening in both the US and the EU, the Brazils of the world would be freer to move forward in other areas and impasses could turn into deals.

Brazil and the US always held the key to resolving both the WTO and their "hemispheric" differences. Yet things would become more and more complicated after July 2006, when negotiators failed one more time in Geneva to strike a deal regarding the last phase of the Doha negotiations. Unlike the Hong Kong Ministerial Conference when the guilty party was for the most part the EU, the US would get stuck on domestic agricultural subsidies in mid-2006 just as congressional elections loomed large on the horizon. While the G20 asked for an annual ceiling of US$12 billion and the EU proposed US$15 billion, the US had great difficulty lowering its previously offered US$22.5 billion cap. The US would be isolated in the negotiations because the G20 had given signs of movement on industrial tariffs and the EU on agricultural tariffs – the other two sides of the "ultimate triangle". The ball was in the US's court, but Congress would not only forcefully oppose any movement but also decide to threaten to end Brazil's and India's preferences under the so-called Generalized System of Preferences (GSP). In the case of Brazil, a full linkage was established between such punishment and Brazil's alleged bad blood in both the hemispheric (FTAA) and global (WTO) realms.

The main underlying notion when looking at Brazil and the US in the context of the emerging trade regime is that neither side is *only* playing games or flagging ideologies. The nature of the Brazil–US trade relationship, despite apparent evidence to the contrary, is tough, level-headed, and hard-bargained – just like any significant trade relationship should be. Neither side has a monopoly on free trade – or its opposite for that matter – while both sides need to negotiate crucial internal hurdles. The timing of all trade matters is also of the utmost importance. It is difficult to press for further openings when the political system rejects it wholesale. The situation in the US regarding trade agreements is particularly illustrative: CAFTA-DR approved by a couple of votes, Peru and Colombia meeting opposition, a renewed demand from a new Congress to press for labor and environmental clauses and disciplines.

Perhaps the most serious consequence of Washington's hesitating trade policy is that it gives all the reasons the Lula Government needs to repeal a bullish trade agenda. In addition, it borders on justifying Brazil's current bent on South–South relations, which is politics intensive and fails to produce any contestability of relevance in the Brazilian market. It is a sad state of affairs, but the fact is that, without a good push from outside, Brazil is not known to naturally gravitate towards free trade.

Conclusion: the way forward

Old leaders must lead. New leaders must join them. Despite bullish trade markets, trade policy regimes around the world need to be on a constant watch and the multilateral trading system is still the best tool around to rein in "unrea-

sonable" regionalism, bilateralism or even unilateralism. Countries could, of course, make good trade policy on their own – and some, indeed, have. The chance of that happening in some parts of the world, however, may be small as trade gets confused with other things and foreign policy aims take over. Others may feel like the internal agenda is just more important than an external agenda heavily-laden with trade concessions. Yet others may feel that their own governments have failed in bringing domestic markets to par with developments elsewhere in the world and want to put a price on their commitment to trade liberalization: further trade liberalization only once needed reforms are in place, and not the opposite.

The WTO represents the most difficult test in the second half of the millennium's first decade. If it manages to keep the system alive with a breath of fresh liberalization, the multilateral system may have a chance of preserving its relevance for real-world trade. If it does not, however, it will not only risk its own credibility but also send a very dubious signal to capitals around the world. It is imperative that the Doha Development Agenda (DDA) be given high priority and be saved from its own complexity by pragmatic leaders that can see the systemic value of the round, the agreements, the organization. Only then can an FTAA or any other regional or bilateral construct make sense and contribute to an increasingly predictable and transparent trading system.

Notes

1 Foreign Trade Secretary in Brazil's Ministry of Development, Industry and Foreign Trade (1999), Deputy Secretary for International Affairs in the Ministry of Finance (1996–1998), and Economist at the WTO (1988–1996).

2 *Fowler's Modern English Usage*, 1968 edition, defines a near miss simply as "a miss that was nearly a hit." The 1996 *Fowler's* omits the phrase, which suggests that it's no longer deemed worthy of discussion. In trade policy, however, it may still prove very useful in some situations. Quoted from "Language Corner", *Columbia Journalism Review*.

3 "Cotton Concession Gives Bush Fast Track Authority", *Organic Consumers Association*, 7 December 2001 (available at www.organicconsumers.org/corp/fasttrack121101.cfm).

4 For an interesting anticipatory article, see "Achieving Trade Liberalization: Why the US Should Challenge the EU at Cancun", by Sara J. Fitzgerald and Nile Gardiner, Backgrounder 1686, Research: Trade and Foreign Aid, *The Heritage Foundation*, 8 September 2003.

5 This turned out to be Pascal Lamy's last shot at a trophy before he moved on to replace Dr Supachai at the helm of the WTO. The fourth EU-Latin America/Caribbean Summit in Vienna (Austria) on 12 May 2006 would also corroborate the common perception that neither side is really in for the long haul. Renewed talks in November 2006 in Rio would reveal much interest from Brazil and MERCOSUR but not much from the European Union, indicating that Brussels was not yet ready to admit to Doha's irrevocable death. A major element in the EU's position vis-à-vis MERCOSUR had indeed been the wish to exhaust all multilateral possibilities before "giving in to" a bi-regional agreement.

6 See more on the FTAA and the US–Brazil relations below under "The Quagmire: US meets Brazil".

7 The term was first used by Fred Bergsten in "Competitive Liberalization and Global Free Trade", APEC Working Paper No. 96–15, Washington, DC: Institute for International Economics, 1996.
8 The term was first used by Jagdish Bhagwati in "US Trade Policy: The Infatuation with Free Trade Areas", in J. Bhagwati and A. Krueger, eds, *The Dangerous Drift to Preferential Trade Agreements*, Washington, DC: American Enterprise Institute, 1995.
9 For a post-Hong Kong Brazilian private agricultural sector "oppositional" digest see "Muito barulho por nada", by Pedro de Camargo Neto, in *Valor Econômico*, 20 December 2005.
10 For more on the Brazilian trade-policy-making process see Marconini, M. "Trade-Policy Making in Brazil", The Inter-American Development Bank, the University of Toronto and the Inter-American Dialogue, Washington, DC, 23 March 2005.
11 See Lopez-Cordova and Moreira (2003).
12 Even within South America, the approach to agreements has been highly questionable to both analysts and industrialists.
13 Only a few days after a state visit to Beijing by President Lula, Chinese authorities stopped a shipment of Brazilian soybeans in the middle of the China Seas on account of alleged contamination. Both countries have been at odds over this issue ever since. In the meantime, however, the Lula Government has conceded market economy status to Beijing and hesitated for as long as it could on the application of special safeguards against Chinese imports as per China's Protocol of Accession to the WTO. The private sector has openly criticized the government for its leniency with Beijing on trade matters.
14 See the "Doing Business Survey" at www.doingbusiness.org.
15 Brazilian Association of Infrastructure Development, ABDIB, available at www.abdib.com.br.
16 The problem here has been the government's "Public–Private Partnerships", which have been rejected by Congress a few times under pressure from the private sector for its original interventionist character.
17 Brazil has two "Economic Complementation Agreements" with Mexico: the ECA 53 which applies fixed preferences to around 1,300 products signed on July 2003, and the ECA 55 which applies only to the automotive sector. Sixty percent of Brazilian exports to Mexico are automotive. Of an annual surplus of over US$3 billion, half can be directly traced to the ECA 55 agreement.
18 "Amorim indica secretário avesso à Alca", in *Folha de São Paulo*, 2 January 2003.
19 Clearly, something like the opening of the ethanol market in the US could make an FTAA highly interesting to an otherwise reluctant Brazil.

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5 Trade liberalization as a moral imperative

Richard Fisher

I am thrilled to be at Baylor University. I have some emotional attachment to this school because of my wife's family. If you walk out this door, the first portrait on your right is of her grandfather. A women's dormitory is named after my wife's grandmother, one of my all-time favorite in-laws. So Baylor is part of the culture of our family.

I want to tell you a great story about the World Trade Organization meeting in Seattle in 1999, which seeing Dr Supachai brings to mind. After we had dinner together, he and I went back to our hotels. The riots had started. Ambassador Barshefsky, our US trade representative, and I were taken by the Secret Service and locked into separate rooms on separate floors. We could not get out unless the Secret Service let us out. We realized the summit was all over. I picked up the phone and called American Airlines and managed to book a flight out the next night at midnight, the red-eye back to Washington.

Five of us were able to do this. For our protection, the Secret Service decided to put each of us in a separate car and drive us to the airport with an armed guard. In the basement of the hotel, I got in my car, protected by a very young police officer. We pulled out of the hotel, and within five minutes I felt like Nelson Rockefeller in Latin America. Demonstrators surrounded my car, pelting us with eggs and throwing rocks.

Sweat started to trickle down the young police officer's neck, and he took out his sidearm. I said, "What the heck are you doing?" He replied, "I need to protect you." I said, "Hold it, just stop. How old are you?" He said, "I'm twenty-eight." I said, "Well, I've been through this before, so let me take care of it."

The car was now surrounded by demonstrators. I told the officer to stay seated, to put his sidearm back in his holster. As I got out of the car, a woman rushed up to me. I can remember the veins popping out of her neck as she screamed, "You capitalist pig." I had not heard that particular insult since 1968. So with everybody yelling and her right in my face, I grabbed her by the shoulders. The crowd fell silent. I said, "What did you call me?" She said, "You're a capitalist pig." I addressed her directly: "Young lady, in 1968 I stood where you are standing, and if you are not careful you are going to grow up to be just like me." The leader of the group shouted, "He's a great guy. Let him go." So we zipped right off to the airport.

Today, I just want to make some points on the idea of a Free Trade Area of the Americas, looking at it as a former practitioner of the art of trade negotiation. I do not think there is any doubt concerning the theory of trade. It is rooted firmly in the sound economics of Hume, Smith, Ricardo, Marshall, and Keynes – and, more recently, Friedman and Lucas. Greg Mankiw, former Chairman of the Council of Economic Advisers, wrote in his wonderful textbook that one of the ten principles of economics ought to be that trade makes everybody better off.

Theory is not the problem. The problem is practice.

When we announced the Free Trade Area of the Americas, I received a call from former Fed Chairman Paul Volcker. He said, “Richard, you don’t have to move forward on all speeds at all times. Trade is a bicycle. Whatever it takes to keep it moving, do it, whether it’s bilateral, regional or multilateral.” Dr Supachai made the same point in his speech last night. It is what keeps things moving forward that counts in our efforts to build grander schemes, such as the broad multilateral rounds that we seem to always have going on. However you can get there, you take advantage of it. The key is political will.

We would never have had NAFTA if not for President G.W. Bush and President Clinton. We would never have had NAFTA if Carlos Salinas and Ernesto Zedillo had not followed through. We would not have had NAFTA had it not been for their Canadian counterparts. As Dr Supachai mentioned last night, we would have never have had an Asia-Pacific Economic Cooperation organization if Bill Clinton had not joined with fellow heads of state and government to push for it in Vancouver.

We would never have brought China into the World Trade Organization if not for a long series of leaders, starting with Nixon and Mao and going on to Jimmy Carter and Deng and his successors. Of course, it took President Jiang Zemin and Premier Zhu Rongji to commit under President Clinton. If not for Prime Minister Khai, Deputy Prime Minister Dung and President Clinton, we would never have had our final agreement with Vietnam, which it was my pleasure and honor to close.

Our bilateral trade agreement with Singapore – which kicked off the Doha Round, by the way – owes a debt to Prime Minister Goh and his ability to take advantage of Bill Clinton’s lousy golf game. It provided the occasion for a dialogue that resulted in a phone call back to us saying we have agreed to go ahead. We would not have had the bilateral trade agreement with Chile without presidential commitment on both sides. We would not have had the free trade agreement with Australia if it had not been for Prime Minister Howard, President Clinton and, later, President Bush to close it. And so on. I think this is very, very important to bear in mind because no trade ministry, whether in the United States or any other country, wants to take the risk of proceeding without a command from on high.

Just a comment about how the USTR’s office works. It has a divided mandate. In the 1960s, it was created not as much by President Kennedy as by the House Ways and Means Committee and its Chairman, Wilbur Mills. My former boss and mentor Michael Blumenthal, when he served as the first deputy

trade representative, came back from an early round of multilateral trade talks in Geneva and reported his progress to Mills. "You did what?" Mills replied. "Forget it. It's not going to happen." Mills reined in the negotiators. Decades later, I spent half my time shuttling between the White House to see a Democratic President and Capitol Hill to see a Republican Chairman of the Ways and Means Committee. Fortunately, Bill Archer was a free trader and incredible leader.

In the Senate, there was Phil Gramm, a Republican who was the best free-trading senator we dealt with. Half the people in Texas did not like me one bit because I had run for office on the other ticket. Gramm paid Charlene Barshefsky and me the greatest compliment when he said, "If I spent all my time buying things for my mama and selling them to you, I would go bankrupt." I could not quite figure out what he meant at first, but I got it after a while and decided it was a great compliment.

The issue of serious political willpower is, I think, a very important principle we need to understand, and I think it gives you a little sense of what it will take to accomplish free trade in the Americas. The political willpower has to come from a demonstrated economic necessity as well as a moral imperative. Unless it does, you are not going to get very far. The Free Trade Area of the Americas was a concept originally advanced by the first President Bush. It was actively engaged by Bill Clinton. At the beginning of this current administration, it received significant attention until other matters distracted the President's attention. My opinion is that the FTAA is just not on the table right now.

Why not? It is because we are not getting the leadership from the very highest levels in the United States, largely due to the focus on other priorities, and because our counterparts in Latin America are not providing the necessary leadership.

I think there are two reasons for that. One is just the practice. We note from history that reaching a free trade agreement requires total commitment. The best example we can cite is President Carlos Menem, who almost unilaterally set up MERCOSUR to prepare for the FTAA. He cut Argentina's tariffs from an average of 40 percent to 10 percent – but that was the easy part. More difficult were all the domestic reforms that had to come with a free trade agreement, especially the labor market reforms. Unless you can hire and fire people, unless you have flexibility in the labor force, you cannot adjust to new economic circumstances. And what happened in Argentina was that there were no labor market reforms. As a result, the economy worsened rather than improved under Menem because there was no flexibility.

The other difficulty with regard to the FTAA involves engaging Brazil's Foreign Ministry, which controls the Trade Ministry. When you walk into the Foreign Ministry in Brasilia, you round an interesting stairwell that has no banisters but goes up to the top of the hall and the Foreign Minister's office. The first thing you are greeted with is a gigantic portrait of Dom Pedro II, the Emperor of Brazil. This led me to think, the first time I saw it, that Brazilians are a lot like Texans. Brazil is big but thinks it is even bigger. And like Texans, they

are always trying to figure out how to stick it to the United States. That mentality pervades Brazilian foreign policy.

Until we are able to engage Brazil directly, recognizing its unique view of its role in Latin America, we cannot complete a free trade deal for the Americas. We have tried everything possible. We had a little tactic for about two years to separate off the Argentines by offering them special concessions. It turned out the Brazilians could not care less what the Argentines think. They were still going to do it their way. We thought an agreement with Chile would get the process of hemispheric free trade started. Of course, it is now thought that the Central America Free Trade Agreement plus the Dominican Republic will act as a catalyst. I assure you that unless we get Brazil intimately involved, unless there is a moral imperative for Brazil, it will not happen.

The current President of Brazil and the current President of the United States are more alike than anybody. They are plain-speaking, straightforward people, and it is one of the oddities of history that a great labor leader can sit down with a former Texas governor and actually get along. Until Brazil and the United States can agree, though, free trade in the Americas is not going to happen.

I like to look to two interesting leaders as models on free trade. Probably the greatest free trade president of the United States was Grover Cleveland. The press makes fun of me on this, but I am serious. Cleveland was a former New York governor and a brilliant man. He played a parlor game in which he would ask for a sentence in English, then translate it into Latin with his right hand and into Greek with his left.

Cleveland took office at a time when US tariffs averaged nearly 50 percent. In those days, tariffs were an important source of income for the federal government. Yet Cleveland was astute enough to see that tariffs amounted to a tax on his own people, and he was gutsy enough to say so. In his third State of the Union address, Cleveland proclaimed that tariffs and other trade barriers "are the vicious, inequitable and illogical source of unnecessary taxation." He went on to say: "They impose a burden upon those who consume domestic products as well as those who consume imported articles, and thus they create a great tax on all the people." It is amazing that somebody could make that statement in 1890.

If you want to get great inspiration, go back and read Winston Churchill's speeches from 1903 to 1908. England was engaged in a hot debate over protectionism between Churchill, a free trader, and Chamberlain, who wanted to restrict imports. If you pick up Churchill's speeches, they could have been written this week. They are amazingly insightful. Concerning tariffs, Churchill said: "Thinking you can make a man richer by putting on a tax is like thinking that a man can stand in a bucket and lift himself up by the handle." This is the disadvantage trade barriers present to the people.

Churchill actually offers a tremendous lesson for us today in the United States. In economic terms, the United States is a colossus. We have a $12 trillion economy, the world's largest by far. I like to remind people that my state of Texas, with twenty-two million people, produces 21 percent more output than

the 1.1 billion people of India. California produces the same output as China. According to the World Economic Forum in Davos, we are the second most competitive economy in the world. (Finland is the most competitive. I will pocket that. Finland has an economy the size of Connecticut's.)

As the most competitive large economy in the world, the United States has a moral imperative to lead on the trade front. But look at some of our practices. Churchill's speeches were made in the context of a debate over sugar imports. We do not have a Churchill today to make great speeches on one of the most protected sectors in the world, our sugar industry.

My point is, we need great leadership in all trading partners to move forward on the free trade agenda.

Let me give you the best example I can of moral imperative – our negotiation with Vietnam, which I had the absolute thrill and honor to conduct. I was quarterback of my high school football team. My end was named Greg Lavery. I was a lousy quarterback, but I could manage to throw the ball when being rushed. I closed my eyes and threw it as far as I could just to get rid of these big monsters coming at me. And somehow Greg Lavery, a beautiful young man with the grace of a gazelle, would pull the ball out of the air and run for a touchdown. When we graduated, I went to the Naval Academy and he joined the Marine Corps. On my nineteenth birthday, he was walking across a rice paddy in Vietnam and was felled by a single sniper bullet to his right temple.

That was in 1968. In 1999, I found myself sitting in a Hanoi negotiating room. I was visiting Prime Minister Khai, who had lost his family in the war with the United States, just as I had lost my best friend in the war with Vietnam. I carried in my pocket a rubbing of Greg Lavery's name from the Vietnam Memorial, and I kept thinking, I have to do this. We have to reach an agreement. In the agreement with Vietnam, we ended for all time the hostility that had divided us. That is the power of trade. That is the good part of trade. It fell to President Clinton to finally close that chapter in history, and as a final footnote, it was one of George Bush's first foreign policy acts as President to sign that agreement. He very kindly had me invited to Blair House to witness the event. We put the Vietnam War to an end after all those years, and my best friend's legacy was finally able to rest in peace. That is what trade is all about.

Now you find me a moral imperative for an FTAA, and we will move it forward. But until we do that, I do not think it is a possibility.

How is that for a happy note?

But I think it is important for you to realize the difficulties facing the FTAA, and I hope this conference will be able to reignite support for this very important concept. We have the possibility of bringing tremendous advancements and progress to countries throughout the hemisphere that are so much poorer than we are, and I think it is time to get it done.

If we do not get it done, the United States will do fine. In his speeches, Churchill called for Britain to move up to the "superfine processes," his term for what we call high value-added production. He realized open trade would push Britain toward these superfine processes. He was even against any

antidumping laws whatsoever because he knew the value of using the cheapest inputs. If governments want to subsidize their exports and take advantage of their taxpayers, let them, Sir Winston would say. We will not do it to ours. We will take their cheap inputs and move up the superfine ladder. And he was right.

That is what we are doing now with regard to China. Let me give you an example. In a speech I gave yesterday, I mentioned that a factory in Orange, Texas, made a chemical for DuPont called surlin. It had been closed down and the price of Pinnacle golf balls would now rise because surlin was a key chemical used in the coating of those golf balls. As a golfer, I was concerned. Just hours after I left the speech, I received on my Blackberry an unsolicited note from a Chinese supplier. "Dear Ambassador Fisher," it said, "we can sell you surlin-coated golf balls for $4.28 a dozen, or 34 cents each, and they have tremendous distance and spin models."

That is how today's world works. We live in a globalized economy. Ideas move at the speed of electronic impulses. And unless our friends in the deepest and poorest parts of Latin America are able to compete with this, they are not going to make it. If they fail, that becomes a problem for the United States as a security issue. There is your moral imperative for free trade in the Americas.

Part III

Regional and subregional agreements in the Western Hemisphere

6 Regionalism in North America

NAFTA and the Mexican case

Víctor López Villafañe and
Mariana Rangel Padilla

After twelve years of the North American Free Trade Agreement (NAFTA) many assessments of its effects have been made by scholars and policy-makers, so at first it would seem irrelevant to do one more. Yet, it is interesting to review NAFTA lessons from the Mexican perspective again because of three major events that occurred in 2005. First, after a loss of momentum on the integration process, new initiatives have been discussed or agreed upon, particularly the North American Security and Prosperity Partnership (NASPP). The second event is that Central American countries signed the Central America Free Trade Agreement (CAFTA) with the United States. Perhaps these countries, by looking at the Mexican example, will be able to prevent some of NAFTA's side-effects by implementing timely policies. The Mexican case could also be useful for the rest of the Latin American economies that are still negotiating free trade of the Americas.[1]

This essay will summarize the main lessons of North American regionalism from the Mexican perspective, keeping in mind that NAFTA is an asymmetrical treaty composed of two developed countries in the US and Canada, and a developing country in Mexico. The first section examines the success stories of trade and investment liberalization and their limits. The second explains how structural problems cannot be resolved automatically and could even worsen in an asymmetrical treaty. The last section analyzes recent attempts of deepening integration, specifically the NASPP.

A first lesson on regionalism from the Mexican case is that in an asymmetrical treaty, trade between the members will grow rapidly, as it did in the first ten years of NAFTA. That is because developed countries (Canada and the US) and developing countries (Mexico) have complementary economies. Yet, the competitive advantage stemming from the removal of formal trade barriers (mainly tariffs) and from cheap labor will eventually recede. Moreover, countries from outside the agreement could build up competitive advantages that allow them to become important economic partners of the developed countries, crowding out or at least seriously affecting the position of the free trade area member lagging behind.

Trade within Mexico, the US and Canada grew at unprecedented rates in the last decade. Total trade between Mexico and the US in 1993 was US$89 billion.

By the year 2000 it was US$275 billion, more than three times pre-NAFTA levels. However, due to the US recession in 2000–2001, increasing Chinese competition, and stagnation of the Mexican economy, in 2003 the amount of total trade had decreased to $252 billion. There was a slight recovery in 2004, yet it is too soon to determine whether or not it is the beginning of another expansion cycle (see Figure 6.1).

Trade with Canada has also grown, though compared to that with the US the amount is still very small. In 1993 the total trade volume between Mexico and Canada was around US$2.7 billion, and by 2004 it was in the order of US$8.1 billion. It tripled in ten years.

In terms of benefited industries, the North American treaty strengthened some Mexican exporting sectors, such as the electronic, automotive and textile industries. The sectors posting greater increases in their production levels are precisely those representing the top traded products, such as machinery and equipment (mainly automotive and electronics) and textiles (see Figures 6.2 and 6.3).

For better or worse, Mexico's foreign trade has concentrated strongly in the United States market. For example, in terms of exports, the US market represented 71 percent of the total Mexican exports in 1990 and by 2003 it was 88.8 percent (see Table 6.1).[2]

With such a level of integration of Mexico's foreign trade, in a few years the dependency on the United States could go up to 90 percent – a fact that could even lead us to rethink the term "foreign trade" for Mexico.[3]

The concentration in the American market has been accompanied by a pro-

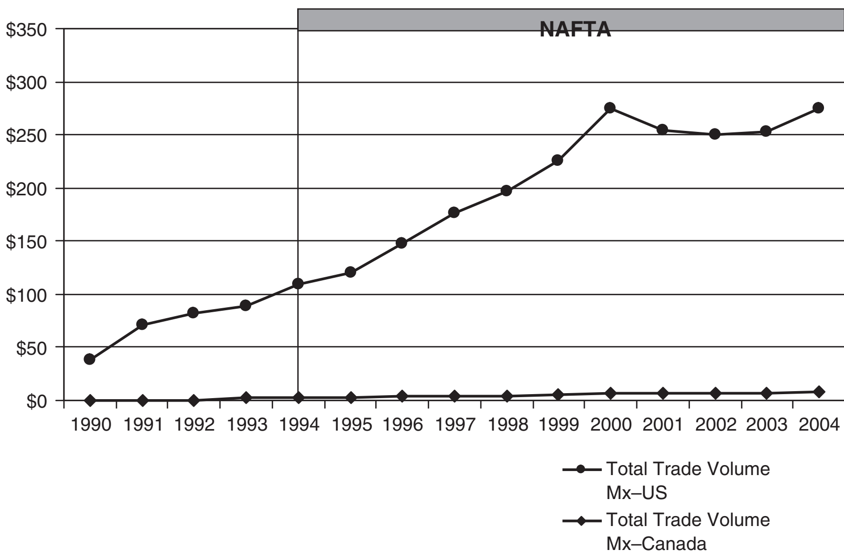

Figure 6.1 Mex–US and Mex–Canada total trade volume (US$ billions) (source: SHCP–Banco de Mexico–INEGI).

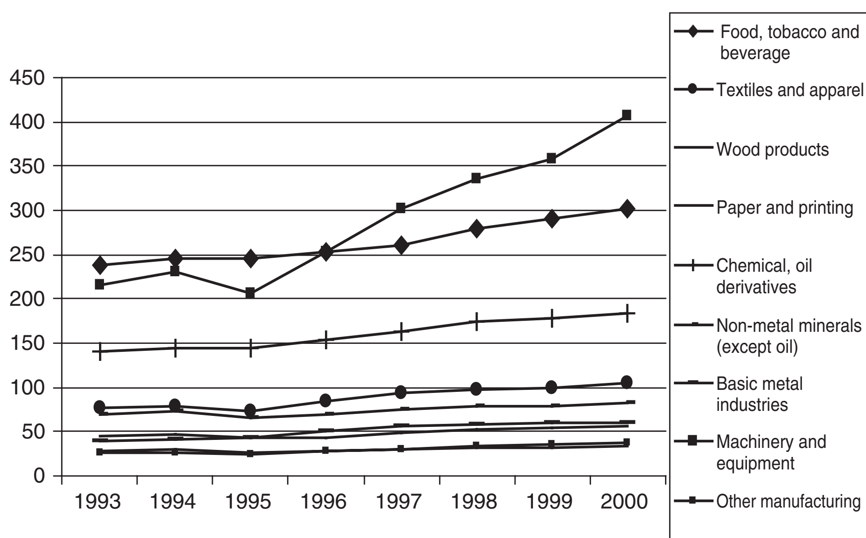

Figure 6.2 Mexican manufacturing GDP by industries, 1993–2000 (billion MXP) (source: INEGI, 2005).

Table 6.1 Top fifteen Mexican exports 2003 (US$ billion)

Total	*165.0*
Crude petroleum	16.8
Passenger motor vehicle, excl. bus	12.5
Automatic data processing equipment	10.0
Telecom equipment, parts, accessories	7.6
Motor vehicle parts, accessories (nes*)	7.0
Lorries, special motor vehicles (nes)	6.6
Television receivers	6.4
Electrical machinery (nes)	6.1
Electricity distributing equipment	6.0
Switchgear etc., parts (nes)	5.1
Furniture and parts thereof	3.7
Internal combustion piston engines	3.5
Office and automatic data, machinery parts, accessories	3.1
Vegetables etc., fresh, simply preserved	2.6
Rotating electric plant	2.4
Base metal manufactures (nes)	2.3
Men's outerwear non-knit	2.2
Medical instruments (nes)	2.2
Measuring, control instruments	2.1
Transistors, valves, etc	2.1
Rest of manufactured products	54.1

Source: UNCTAD (2005), *Handbook of Statistics*.

Note
*nes, not elsewhere specified.

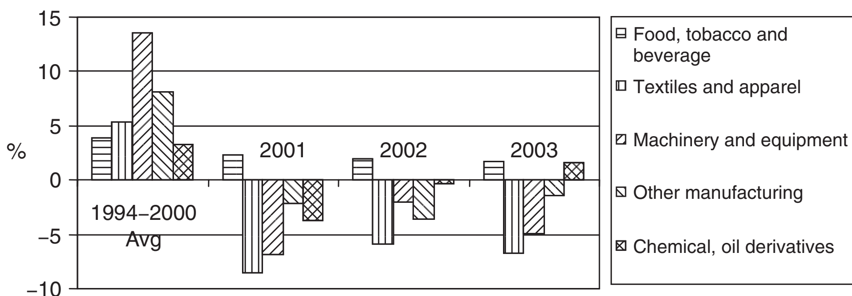

Figure 6.3 Manufacturing industries' growth, 2000–2003 (source: INEGI, 2005).

portional decrease in exports towards Europe and Asia and under-utilization of a wide variety of FTAs that Mexico has signed. In addition to this, 56 percent of the bilateral trade between Mexico and the United States is intra-industry or intra-firm.[4] Mexican globalization means, in fact, a closer relationship with the United States economy. The paradox is that Mexico is even more dependent on the US than are the economies of the states of California or Texas, both of which have a larger global commercial profile than Mexico. What is worrisome is that, since 2001, recession has affected even the most dynamic economic sectors in Mexico, such as machinery and equipment and textiles. Figure 6.3 illustrates the decline of their production levels.

Although Mexico has become one of the US top commercial partners, and even if on average the United States and Mexico trade more than $720 million every day, there are obstacles to the continued growth of such trade: namely, Chinese competition and internal problems.

With regard to Chinese competition, since the year 2002 Mexico's privileged place as supplier of the US market has been surpassed by China, and it seems that the trend will continue (see Figure 6.4). The US is now importing more products from China than from Mexico, even though it has not signed a free trade agreement.

Besides facing external competition, Mexico has internal problems to deal with. Benefits from trade and increased integration have not been equally spread through the economy, and that is an obstacle to the preservation of competitiveness against other countries. North American integration has reinforced the existence of two types of businesses. On one side, the great companies that are oriented to the export market, and have access to foreign financing, have been benefited by industrial restructuring. As Figure 6.5 shows, 300 large companies, most of them multinational corporations, make around 52 percent of total Mexican exports. If maquiladora exports produced by 3,200 assembly plants are taken into account, around 3,500 establishments make up 93 percent of total exports.

Most of the companies that have been successful have developed distribution networks for their products or have reached long-term cooperation agreements

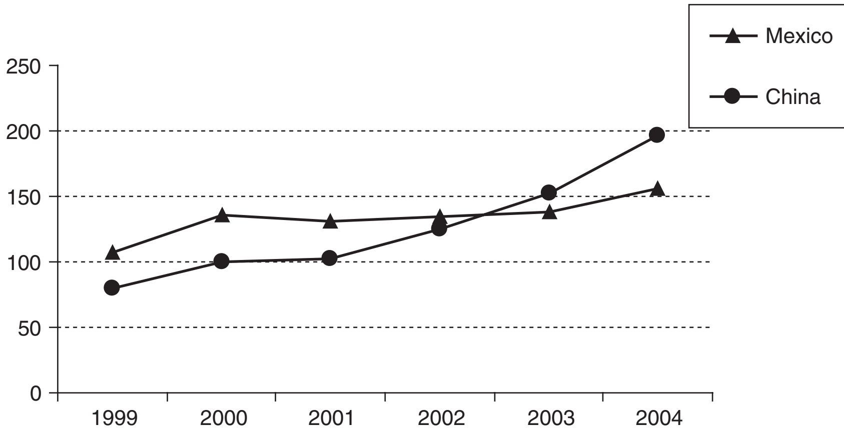

Figure 6.4 Total US imports (US$ billions) (source: US Census Bureau Foreign Trade Data).

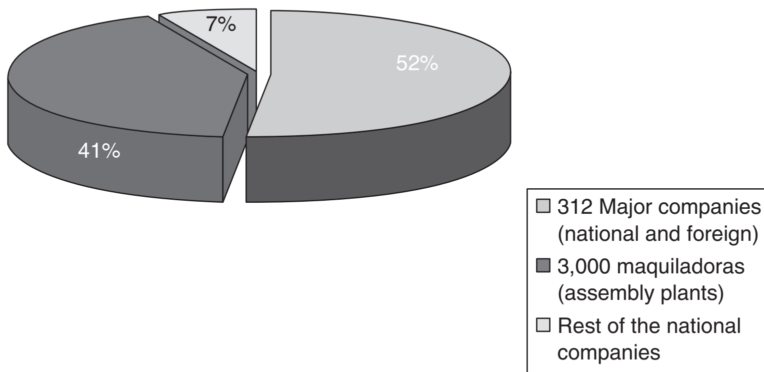

Figure 6.5 Concentration of Mexican exports (source: Dussel, 2000).

and alliances with American or Canadian companies. Their productivity levels are very similar to those of their North American competitors or partners. As has been previously said, the electronics and automotive industries are examples of leading exporting sectors, but their linkages and spillover effects on the domestic economy are minimal. They have a very weak influence in terms of generating domestic employment, and make little use of local suppliers.[5]

On the other hand, there are the small and medium-sized businesses which have to contend with the burden of high financial costs to improve their technological and productive capacity. Furthermore, labor-intensive sectors of the national economy, which provided the foundation of the development in the East Asian economies for a long period of time and that would have also been the base of Mexico's fast economic growth, have not yet experienced NAFTA benefits.

Closely related to competitiveness preservation is the issue of foreign direct investment (FDI) and technology transfer. Foreign direct investment flows to Mexico have been growing since economic liberalization began. From 1994 to 2004 the country received a total of $150 billion in foreign investment, of which 70.1 percent went to the manufacturing sector, 16.1 percent to commercial activities, and 13.8 percent to other sectors of the economy (Figure 6.6). US investment intensified its outstanding role in the Mexican economy after NAFTA. In 1994 it accounted for 46 percent of total direct foreign investment in Mexico, and by 2004 the US share of foreign direct investment in Mexico had increased to 64 percent. This great increase reflects the enormous potential for North American multinational companies in Mexico. Canadian investment currently accounts for a mere 3.6 percent of total direct investment inflows into Mexico.

In terms of the outcomes, foreign direct investment has benefited the country by bringing the capital needed to increase production, increase exports and open up job opportunities. However, technology transfers required to create a positive dynamic of competitiveness growth have not occurred as expected. A recent study revealed that the relationship between foreign capital share in a Mexican industry is not always positively related with increased productivity, the most common measure of technology transfer. On the contrary, sectors with larger foreign shares usually experience negative productivity effects.[6]

FDI can also transfer knowledge through training and research and development activities. A positive note is that foreign companies are training Mexican workers.[7] Yet, investors carry out scant research and development activities in Mexico, mainly because Mexico's innovation system is inefficient, domestic efforts of R&D are very low, and the absorptive capacity measured by the level of researchers per capita is also small.[8]

One more case of a missed opportunity is the near absence of linkages between foreign companies and domestic small and medium enterprises. Most of the foreign companies' inputs are imported, limiting the multiplier effects of

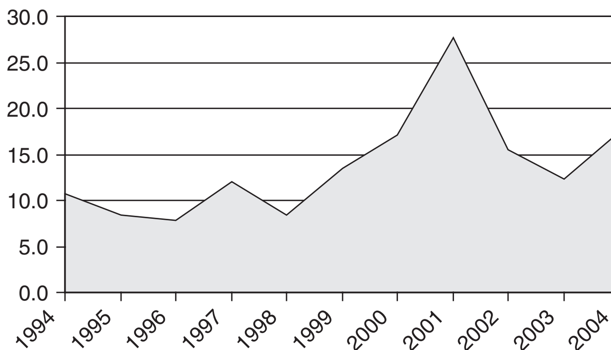

Figure 6.6 Total FDI inflows in Mexico (US$ billions) (source: Mexican Ministry of Economics, 2005).

the products assembled in Mexico. Local sourcing of foreign firms is extremely low, at 3 percent on average.

The scarce local linkages between multinational enterprises and domestic companies, and the small levels of technological transfers, indicate a major failure of the Mexican Government. Over the past twenty years the government has liberalized the economy without a comprehensive industrial policy which would have allowed domestic firms, mainly small and medium enterprises, to benefit from the economic reforms.[9]

It is only very recently that the Mexican Government has developed some strategies to create networks of domestic suppliers, creating strategic plans to support sectors such as information technology and biogenetics. It will be interesting to see whether these plans survive the change of government after the 2006 elections.

An important type of FDI consists of assembly plants, also known as maquila, and these are often seen as a NAFTA success story. They multiplied during the 1994–2004 period (see Figure 6.7). Maquiladoras are an important source of job creation, though they are highly mobile. Furthermore, like foreign direct investment, they also have scarce local linkages.

In 1990 there were around 1,500 assembly plants, and by 2001 they had doubled their number to more than 3,700 factories nationwide. Particularly since 1995, maquiladoras have increased their presence in Mexico. One of the main reasons was the peso devaluation resulting from the 1994–1995 crisis, but above all NAFTA made Mexico an attractive location as a platform to access the American market.

At the beginning of NAFTA, maquilas operated only in the northern part of Mexico.[10] During the NAFTA period, there has been a change in the location of these assembly plants within Mexico. Nowadays the growth rate of maquiladoras south of the border region is increasing rapidly due to government incentives and lower wages. In 1990 only 15 percent of the maquiladoras were established

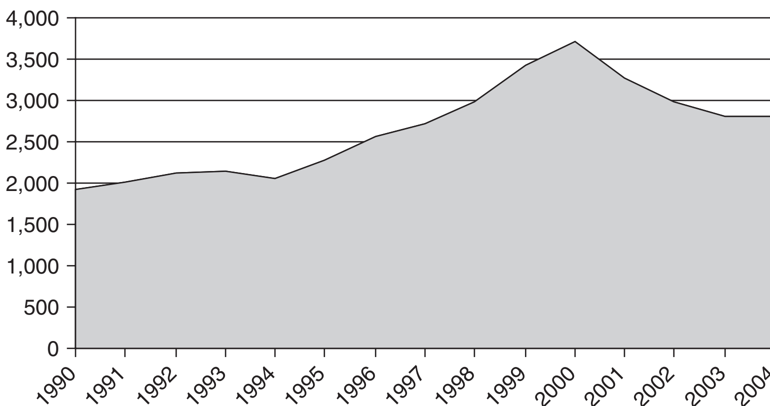

Figure 6.7 Maquila establishments, 1990–2004 (source: INEGI, 2005).

in the central and southern regions of the country, but by the end of 2000 hinterland establishments represented 27.5 percent of the national maquiladora registry and were scattered throughout the whole territory.

Maquiladora industry is one of the most dynamic sources of job creation in the Mexican economy. In 1993 the total number of workers in maquila was 546,000, and by 2000 this figure had increased to 1.22 million workers. However, during the 2001 US recession the maquiladora industry suffered a major setback. Many establishments shut down operations and jobs were cut. The number of plants fell from 3,700 to 2,791 in 2003. Jobs in this sector decreased from 1.3 million in 2000 to one million in 2003. Economic recovery began in the year 2004, but the maquiladora industry has not yet shown the same dynamism that it had previously. The economic crisis revealed the highly mobile character of this type of industry and a loss of competitive advantage in terms of wages in Mexico. Many maquiladoras fled to China and to Central America, where labor costs are lower and raw materials cheaper. This trend will probably continue now that the CAFTA has been signed.

As is the case with FDI, maquiladoras also use a very low level of domestic inputs (Figure 6.8). The national average is around 2.3 percent of the total. The percentage is lower in border states where maquiladoras have a stronger presence.

Mexico is now facing a big challenge regarding how to maintain the maquila industry. It seems that its geographic position, the more or less skilled labor force, and natural resources will help the country to remain competitive. For example, the assembly plants that have survived are mainly those with sturdy end-products such as household appliances. It also seems that in the case of the border, the more-or-less skilled labor force has also become a factor in helping to restructure maquilas into higher-technology production that in some cases requires a skilled labor force. Finally, Mexico has a wide range of natural resources. Nonetheless, there needs to be a strategy to remain competitive.

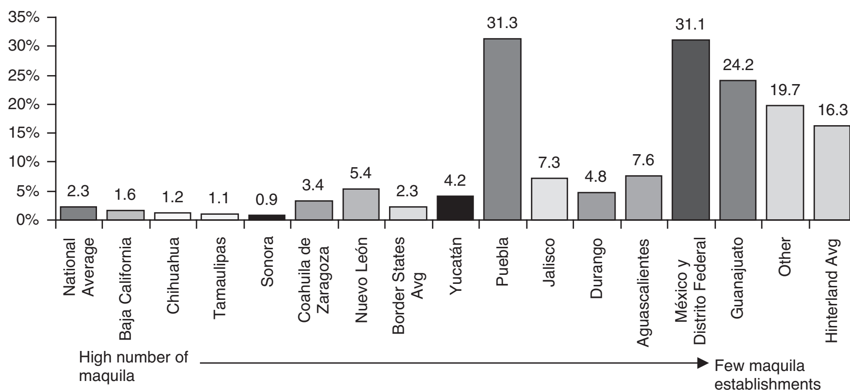

Figure 6.8 Percentage of domestic inputs in maquila industry by state, 1994–2000 (source: INEGI, Estadistica de la Industria Maquiladora de Exportación).

Mexico has to improve and expand its communications and transport infrastructure. At present the network has proved insufficient for the size of the interaction between Mexican and North American companies. Increased education and training efforts led by the government and major educational institutions will also be required.

To sum up the first lesson, Mexico has benefited from asymmetries and free trade with its North American partners. It has also attracted large FDI inflows and assembly plants. Yet the country and its partners need to find a way to keep its competitive advantage. Low wages no longer provide sufficient cost advantage to attract foreign capital to Mexico. Long-term industrial and educational policies, as well as increasing R&D funds, are key.

Another important lesson from NAFTA is that liberalization without adequate policies and mechanisms to secure the distribution of benefits will perpetuate or even increase structural problems in the smaller country. The Mexican case reveals what free markets cannot do. If there are no coordinated efforts to address the structural weaknesses of the smaller country in the asymmetrical free trade area, its problems will become a major obstacle to further integration. At least that is Mexico's experience, where poverty and inequality continue to exist, fuelling illegal migration and criminal activities such as drug trafficking and violence. All these issues create tensions with Mexico's trading partners, particularly the US.

Economic liberalization has not translated into high and sustained levels of growth, as Figure 6.9 reveals. It is worth noting that China's GDP has grown at an annual rate of around 10 percent while Mexico's average growth rate has been almost 3 percent.

Along with economic growth, the issues of poverty and inequality must be considered. NAFTA did not create poverty and inequality in Mexico – those problems were already there – but trade and foreign investment have not been used as a lever to improve the situation. Over the years 2000–2005, poverty

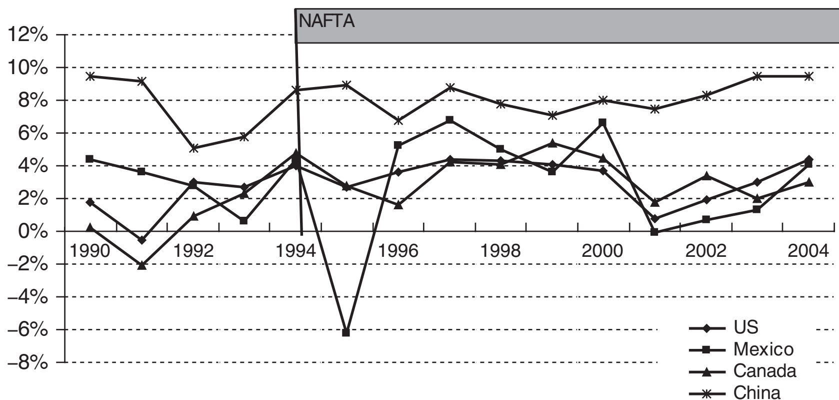

Figure 6.9 NAFTA countries + China GDP growth, 1990–2004 (source: INEGI; BEA; Statistics Canada, 2004).

Table 6.2 Household income distribution (share of total income)

Year	*Poorest 40%*	*Next poorest 30%*	*20% below the richest 10%*	*Richest 10%*
1989	15.8	22.5	25.1	36.6
1994	15.3	22.9	26.1	35.6
2000	14.6	22.5	26.5	36.4
2002	15.7	23.8	27.3	33.2

Source: CEPAL (2002) Panorama Social de América Latina.

rates have decreased somewhat. Nevertheless, 39.4 percent of the total population still lives in poverty. Perhaps more so than poverty, income inequality seems to be the most serious challenge for Mexico. Inequality levels have been high since the debt crisis in the 1980s and the implementation of structural adjustment programs. During the first four years of the 1990s, before NAFTA came into effect, inequality receded; however, the financial crisis and peso devaluation of December 1994 reversed the trend. As Table 6.2 reveals, income distribution has been remarkably stable despite significant economic liberalization.

The fact that income liberalization has done surprisingly little to help poorer people can be partly explained by the concentration of liberalization benefits in a few hands and regions. As has already been mentioned, an economic polarization process might be underway, since 90 percent of the manufacturing exports during the 1993–1999 period were made by only 3,500 companies. Furthermore, social and regional inequalities are a huge challenge. For instance, Hanson (2003), who examined the evolution of wages in Mexico from 1990 to 2000, concluded that wage gains were largest in the regions most exposed to international trade and foreign direct investment, implying that other regions, mainly in the south of the country, have not experienced the liberalization gains.

There seems to be room for positive expectations, as figures for the year 2002 show an improvement in inequality levels particularly in the two poorest strata. However, there is still 40 percent of the population living at only 15.7 percent of the total national income. Another major concern that has emerged is job creation. Even if trade has increased, FDI has flowed into the country, and maquiladoras have arrived, not enough jobs have been created in the past ten years. It is true that since NAFTA came into effect and Mexico recovered from the 1994 crisis, the unemployment rate has been low, averaging around 3 percent per year. Yet this is due more to an expansion of the informal sector, which employs more than 40 percent of the workers in the country, than to dynamic job creation.[11]

The job creation challenge is mainly fuelled by high population growth rates that caused an expansion of the Mexican labor force from 32.2 million people in the early 1990s to 40.2 million in 2002. This means Mexico needed to create almost a million jobs per year to be able to absorb the labor supply growth. A recent study found that between 2000 and 2004 Mexico had an employment deficit

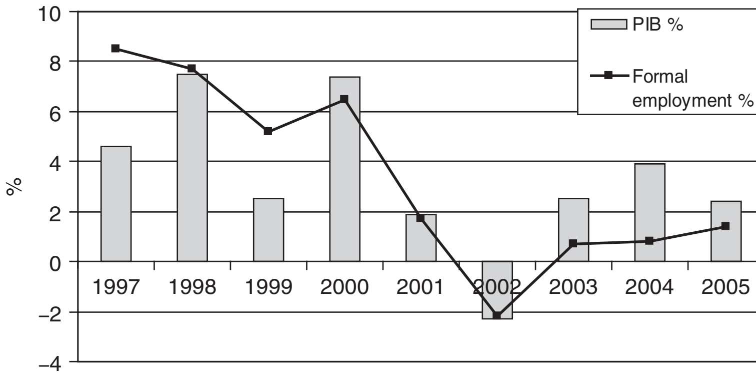

Figure 6.10 GDP and formal employment growth rates (source: Cabrera, 2005, with data from INEGI and STPS).

Note
Formal employment refers to workers with social security benefits (IMSS).

of 3.3 million jobs that were not created. Of the people that did not have employment, 42 percent entered the informal economy, 36 percent migrated to the United States, and the remaining 22 percent are registered as unemployed labor force.[12]

Figure 6.10 illustrates the loss of formal employment in manufacturing. According to the Mexican Social Security Institute (IMSS), between October 2000 and April 2005 the manufacturing industry lost 824,000 jobs.

As a result of poverty and unemployment, migration has become one of the few alternatives to escape marginalization. There is a long-standing tradition of migration of Mexican workers towards the United States, and in recent years migration rates have increased.[13] When NAFTA was under negotiation, Mexico wanted to open a broad dialogue on all forms of migration with NAFTA partners, but the issue was left off the agenda. The only provisions for migration in the agreement deal with short-term business travel and the movement of professional workers.

NAFTA negotiators expected migration would decrease as the influx of North American companies would create jobs in Mexico. President Carlos Salinas even declared, “Mexico will start exporting products instead of exporting workers”. Nevertheless, his prediction is far from becoming fact. The US Immigration and Naturalization Service estimates that the number of Mexicans living in the United States without authorization rose from two million in 1990 to 4.8 million in 2000. Some of those migrants return to Mexico after a few years, but others settle down and even bring their families with them.[14]

Official data reveal that each year around 410,000 Mexicans leave the country for the US looking for better opportunities (see Figure 6.11). The size of Mexican-born population in the United States is another way to grasp the degree of migration: in 1990 there were around 4.5 million Mexicans living in the US, while by 2003 there were close to ten million.[15]

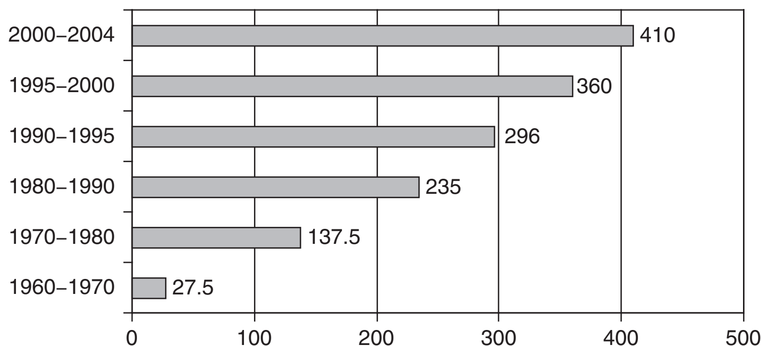

Figure 6.11 Annual flow of Mexicans to the US (thousands) (source: CONAPO, 2005).

Besides increasing migration, high levels of poverty and inequality plus the re-structuring of politics and power occurring in Mexico have led to an increase in violence and organized crime in cities, particularly those near the border with the US, such as Tijuana, Ciudad Juárez, and Nuevo Laredo. In the cities, executions, murders and cross-fires are frequently in the news, and the authorities have been unable to cope with this. The paradox is that these cities were on the "winners" side of NAFTA, experiencing an economic boom. Along with trade and investment came illegal activities and marginalization of some groups. In the medium and long term, insecurity and violence threaten not only their citizens but also their economy.[16]

Free markets have proved not to be the solution for problems such as poverty, inequality, migration, and organized crime. Therefore, in defining a viable development plan Mexico is at crossroads. Will it look further into its domestic market or will it continue to rely on the North American option? So far, it seems it will choose the latter.

Having examined some of NAFTA's lessons, we will now turn to analyzing how the situation has evolved in the year 2005.

After twelve years in operation, the North American Free Trade Agreement has probably reached its peak in terms of trade and foreign investment increase. There is also a rise in competition faced by the North American region vis-à-vis other regions and countries, mainly China. Meanwhile, the changing international scenario, particularly after the 9/11 attacks, placed the issue of security at the top of the agenda in both the US and Canada. Since 2001, governments in the North American region have set up some new cooperation initiatives, such as the SMART border agreement. Academics have explored different integration possibilities as well.[17]

Some strategic moves at the governmental level took place in 2005. In March the North America Security and Prosperity Partnership was signed by Presidents George Bush, Paul Martin, and Vicente Fox at Baylor University in Waco, Texas. According to the official declaration, the NASPP "will further enhance our economic collaboration and help to ensure the continued growth and com-

petitiveness of North America, while improving the quality of life of our citizens".[18]

However, it is important to point out that, in a region characterized by asymmetry, prosperity and security can have very different meanings for each country. Such is the case of Mexico and US–Canada. As evidence in this paper has revealed, Mexican prosperity is more related to reducing poverty and inequality than, for example, sharing a tag system on textiles and clothes or encouraging e-commerce.[19] The same happens with the interpretation of security: while in the US–Canada security is an issue of external threats and terrorism,[20] for Mexican citizens security has to do with internal violence and drug-trafficking problems.[21] Unfortunately, it seems leaders and policy-makers have ignored asymmetries in their NASPP negotiations.

So far, the NASPP reveals little to help Mexico deal with its structural problems. The Report to the Leaders of June 2005 and the press release of the Mexican Executive on 23 March 2005 make some reference to supporting, for example, small and medium enterprises and education efforts in Mexico. Yet they are very vague statements. No structural funds to close the asymmetries have been assigned either, and the migration issue has been completely omitted again.[22]

The regional structural funds issue has been discussed in academia, yet it creates huge controversy. While some intellectuals stress that Mexico needs help from the US and Canada to deal with its problems, others state that Mexico should first make efforts on its own and then get help from its neighbors.[23]

Furthermore, behind recent proposals and negotiation there is one clear idea: that in North America there are different integration speeds. This appears very clearly in Canada's International Policy Statement: "Canada and its continental partners have engaged in a different process of market making. Cooperation is managed through common rules, rather than centralized institutions, and functions at different speeds depending on the particular problem in need of resolution" (Department of Foreign Affairs and International Trade, 2005: 6).

In the Report to the Leaders of North America, if one examines the cooperative initiatives, it is evident that those related to strategic defense and standard harmonization improvement are much more developed between Canada and the US than at a trilateral level including Mexico. So far, there is no problem with the idea of different speeds. In fact, we have to recall that NAFTA was preceded by the US–Canada Free Trade Agreement. However, the main problem is whether this time Mexico's internal problems will allow the country as a whole to keep pace, or whether internal polarization will hinder any kind of deepening integration.[24]

On this matter, Mexican policy-makers and academia are lacking a thorough reflection of what Mexico's main objectives, internal and external, will be for the coming years. Politicians are only thinking about the next elections, while academia is preoccupied with internal issues like poverty, drug-trafficking, and democratic transition. Very few debates have been held regarding the North American Prosperity and Security Partnership issue. Without adequate debate,

Mexico will again let go an opportunity to negotiate a better situation for its citizens. That has already occurred: when NAFTA was negotiated in the early 1990s priority issues such as migration, agricultural subsidies, and structural asymmetries were left out of the talks, and ten years later not only Mexico, but also the US and Canada, are suffering the consequences.

Besides facing domestic and regional challenges, Mexico has to design a strategy to deal with the Chinese Dragon. Throughout different sections of this paper a matter that has constantly emerged is the increasing competition that Mexico confronts from China. The issue is so important that it deserves further analysis.

Mexican and Chinese paths cross at two points: internally with the continuous increase of both legal and illegal Chinese imports, and externally in their competition for the United States market. Arellano (2005) notes that despite the fact that Mexico surpasses China in different aspects of competitiveness, such as regulation, intellectual property protection, skilled labor productivity, transportation costs to the United States, and preferential access to that country derived from the NAFTA, China keeps increasing its penetration of the US market. Figures show that in 1990 China accounted for 3.1 percent of US imports while Mexico accounted for almost double that amount with 6.1 percent. That situation has radically changed. In 2004, China held 13.4 percent of the US market against 10.6 percent held by Mexico.

When examining Chinese competition in North America, there has been a misleading analysis which considers China's presence to be a new phenomenon or a recent threat. In fact, Chinese competition has been present in the region at least since the beginning of NAFTA. Two main periods can be established in Mexico–United States–China relations. The first is from 1994 to 2000, during which Mexican foreign sales experienced a growth of 22.7 percent – a higher rate than China's, which grew at 21.2 percent. The second period began in 2001, when Mexico's foreign sales stagnated and at some point even decreased, in contrast to Chinese participation, which kept growing. In 2003 China finally surpassed Mexico as the second most important foreign supplier of the US. Mexico is currently located in third position, with exports worth US$155,843 million sold to the United States in 2004. In the same year, China sold exports worth US$196,699 million to the United States.

As a result of this level of imports and a lower level of exports, the US has a huge trade deficit with China, which in 2004 amounted to $160 billion. In contrast, the US trade deficit with its NAFTA partners, Canada and Mexico, that same year was US$112 billion, of which $66,826 million belonged to Canada and US$45,067 million to Mexico. One of the risks in the Mexico–United States–China equation is in the further displacement of Mexican industries, products, and workers.[25]

The second level at which Mexico confronts the Chinese challenge is in the Mexican domestic market. Since 2002 China has become Mexico's second most important trading partner after surpassing Japan in the provision of imports, with an annual growth of 26.3 percent in Chinese imports to Mexico between 1993

and 2003. According to Dussel (2004), imports are mainly for the autoparts, electronics, toys, and shoe industries. In terms of exports to China, Mexico has concentrated on primary goods, and it is the only country in Latin America that has a trade deficit with China.

What can a country like Mexico do to confront the Chinese challenge? Dauderstät and Stetten (2005) outline three alternatives. The first is to take advantage of products that have not been touched by China, as India did. The second is to sell China products such as coal and oil – which the Dragon needs in great amounts. This has been the Brazilian strategy and, to some extent, Mexico's. However, given Mexico's trade deficit with China, this strategy is probably unsustainable. Finally, there is the possibility of benefiting from China's economic "upgrade".

Mexico has an opportunity related to the fact that China is facing intense trade friction with the US, derived from its large commercial deficit. Even if, as Balderrama (2005) argues, this situation has benefited many American businessmen, it cannot continue for long. Therefore China will probably adopt new strategies in order to minimize the US political backlash. Such strategies might be similar to the pattern adopted in the 1980s by Japanese authorities to deal with the so called "Japan bashing" and protectionism. Such a strategy involves an increased economic engagement with other economies in North America, and the creation of productive networks to conduct business directly in the NAFTA region. By this logic, Mexico and Canada could become new sites for Chinese direct investment and joint ventures that would require the use of local technology and work force.

Mexico could be at a turning point at the beginning of 2006. Its situation could be modified towards a further rapprochement with China. This means that the position of Mexican policy-makers and businessmen, that China is nothing more than a menace to the Mexican economy, should be transformed. That would partly depend on the deployment of a sound and wise strategy towards China, as well as on China's own domestic and international stance.

Conclusions

To sum up, after more than a decade of NAFTA Mexico shows a stronger economic dependency than before upon the US, with trade and investment having grown exponentially. Mexican GDP growth rate was not similar to the trade expansion rate because the latter was largely concentrated in multinational companies, a few big domestic firms, and maquiladoras in the US–Mexican border. Overall, NAFTA has not been able to serve as an instrument for improving the conditions of small and medium enterprises, nor for raising the standards of living of Mexican workers, except for those linked to the benefited industries mentioned before.

Thus the three main lessons from the Mexican experience of an asymmetrical free trade agreement are:

1 The asymmetrical FTA will widen trade and investment at first, but

competitive advantages will not last forever. Besides domestic limits, tariff liberalization and low wages provide finite advantages.

2 FTAs will not solve structural deficiencies in the less developed country, and could even aggravate them.
3 Adequate industrial and educational policies are needed to use free trade and incoming investment as a lever to expand human capital and reduce poverty and inequality.

Mexico is facing enormous challenges. Chief among these is the need to maintain high economic growth rates accompanied by job creation. Furthermore, the Mexican Government has to develop industrial policies aimed at linking sectors and enterprises, as well as encouraging technology transfers.

Regional and social imbalances ought to be reduced in the domestic arena, while at the international level it is urgent to set up new competitive strategies to face Chinese competition.

Finally, if further regional integration in North America is envisioned, the less developed country, Mexico, should negotiate some support from its partners, the US and Canada. Otherwise it will lag behind them and might never catch up with them.

Notes

1 The year 2005 was when the FTAA should have been concluded, but since the Summit of the Americas at Mar del Plata in Argentina, negotiations have remained stalled.
2 See Enrique Dussel (2000) "El Tratado de Libre Comercio de Norteamérica y el desempeño de la economía en México." Naciones Unidas, CEPAL. The United States was the destination market for 96 percent of all Mexican electronic exports, and for 94 percent of all exports of the automobile industry. The integration of these two sectors in this bilateral relation is so intense that it seems as if they are part of the same country.
3 In some cases, such as companies like the Ford Motor Company in Mexico, 100 percent of their exports are directed towards the United States' market – that is to say, Mexico's Ford Motor Company is a productive space completely integrated with the United States' businesses
4 US Department of Commerce News, 26 June 2001. Of the total imports of Mexico from the United States, 66 percent are of intra-industry origin.
5 See Enrique Dussel, *op. cit.* p. 47. Of the employment generated between 1993 and 1998 in Mexico, 90.36 percent was accounted for by enterprises little related to foreign trade. See also Won-Ho Kim (2000) "The effects of NAFTA on Mexico's Economy and Politics," Working Paper, 00–05, 30 June p. 14. Kim states that most of the enterprises were trying to raise their productivity by reducing their workforce.
6 The study using data from 1994 to 2001 to perform panel regressions on the levels of productivity and their relationship with foreign capital found mixed or even negative results. See Mariana Rangel (2005) "¿Transfiere Tecnología la Inversión Extranjera Directa en México?" In *Revista Comercio Exterior*, *Bancomext*, Mexico.
7 In the same study, Rangel found a positive correlation between the percentage of establishments training their employees in an industry and the percentage of foreign capital in that same industry.

8 The correlation between the percentage of income devoted to R&D and the percentage of foreign capital in an industry is negative and small at –0.065.
9 Mexico lacked an industrial policy in the strategic sense. Salinas de Gortari's industrial modernization project was left to the market forces. President Zedillo had an industrial plan more or less like the Asian style, but it did not assign specific weights to strategic sectors.
10 It has to be recalled that by law maquilas were not allowed to set up anywhere else than the northern border. They had emerged as an employment creation program for the border implemented by the Mexican Government during the 1960s. It was only in the year 2000 that the government allowed maquila operations in the rest of Mexican territory.
11 For a thorough analysis of employment in the NAFTA area, see Sandra Polasky (2004) *Jobs, Wages and Household Income*. Carnegie Endowment for International Peace, and the Report of the North American Commission for Labor Cooperation (2003) *North American Labor Markets. Main Changes Since NAFTA*.
12 Rivero, Arturo (2005) "Crece el déficit en empleo," *Reforma*, 25 January.
13 In 1942 the Mexican Government signed an agreement with the US Government to cope with the wartime labor shortage in the US. The program created a circular flow of around half a million workers and lasted until 1964, when the American Government faced pressure and ended it. However, workers continued to flow in illegally.
14 Some recent studies have found that, due to US immigration policy and Mexican economic performance, permanent migration has increased over the years, altering the circular flows. See Jorge Durand-Massey and Douglas Massey (eds) (2004) *Crossing the Border. Research from the Mexican Migration Project*. Russel Sage Foundation. This has huge social, political, and economic implications for the US–Mexico relationship, although the US has refused to seek a long-term solution
15 The economic impact of migration is huge. Mexican immigrants, particularly those living in the US, send money to their families living in Mexico. Therefore remittances have turned into a major source of capital for the Mexican economy. In 1995 Mexico was the fourth largest recipient of remittances in the world, and by 2001 it became the second largest recipient, with around US$9 billion dollars that year. Just to grasp the dimensions of this phenomenon: in 2003, Mexico received nearly $13.3 billion in workers' remittances, an amount equivalent to about 120 percent of annual foreign direct investment flows from 1993–2004 and 70 percent of oil exports per year. Thanks to remittances, millions of Mexican households are able to pay for education and health expenditures that would not be available to them otherwise.
16 For example, in the last days of July 2005 the US Consulate in Nuevo Laredo shut down operations, and the US Ambassador in Mexico, Tony Garza, has continuously denounced the situation. Although Mexican authorities initially ignored the problems, the number of executions is alarming: more than 100 in the last year. Nuevo Laredo is the most important trade crossing point in the border. Each day around 10,000 trucks and 1,800 rail cars pass through. In an attempt to control the situation, federal troops were sent to replace local police officers who were thought to be linked to criminal gangs, but this has not been enough. Killings and kidnappings persist. See Blumenthal, Ralph (2005), "Texas town is Unnerved by Violence in Mexico", *New York Times* online.
17 On this issue perhaps Canada has produced the most reports and proposals. In the US, Robert Pastor has led the effort. In Mexico, apart from the participation of some academics and politicians in "Building a North American Community Task Force", there has been a notorious lack of analysis aggravated by a lack of strategy and long-term vision by the Mexican Government.
18 Minister David Emerson, in *Canada's Marks Progress on Security and Prosperity Partnership with the US and Mexico*, Public Safety and Emergency Preparedness

Canada, Ottawa, 27 June 2005. Available at www.spp.gov/spp/report_to_ leaders/ [November 2005].

19 *Security and Prosperity Partnership of North America. Report to Leaders*, June 2005. Ministries of State, Economy and Foreign Affairs, p. 8.

20 In Canada's most recent international policy statement it is declared that "The attacks of September 11, and their aftermath, have recast Canada's national security agenda in significant ways. The potential for another terrorist strike in North America remains high, leaving Canadians with a vulnerability that is likely to persist well into the future." See Government of Canada (2005) *Canada's International Policy Statement. A Role of Pride and Influence in the World: Overview*, p. 7.

21 As stated previously in this paper, Mexico is facing increased insecurity levels, mainly in its border cities, that have led to implementation of a governmental strategy called Mexico Seguro.

22 There is an initiative to create a common pass between Canada and the US, yet Mexico is not considered in it.

23 "First, with respect to a North American Investment Fund that the Task Force recommends be established now as a means to improve Mexico's infrastructure and education, I believe that we should create the fund only after Mexico has adopted policies recommended by the Task Force as necessary to improve Mexico's economic development." Council of Foreign Relations (2005) *Building a North American Community. Report of the Independent Task Force on the Future of North America*, p. 38, comment by Carla A. Hills joined by Wendy Dobson, Allan Gotlieb, Gary Hufbauer, and Jeffrey Shott.

24 Certainly, there are some industries and economic sectors in Mexico that will continue to deepen their integration because they are highly competitive and have been able to keep pace. For example, the automotive and steel sectors fall into this category. The same happens with the segment of the population that is well-educated and bilingual. These people will not have any problem with deepening integration. The challenge lies in what will happen with the rest of the population and the economy.

25 An example of the local application of this continuous confrontation can be seen in the case of Arizona. Mexico remains today Arizona's number one trading partner. However, Arizona's exports to China grew 168 percent in 2002, while Mexico's decreased by 15 percent. In 2003 Arizona's exports to China grew by 95 percent, while Mexico's only grew by 6 percent. If we were to rank them, China is today the fourth largest trading partner for Arizona, whereas in 2001 it occupied seventeenth place (see N/A, 2004).

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7 Central America in a free trade area for the Americas

Alberto Trejos[1]

For obvious reasons, many observers often pay scant attention to the role of the smaller countries in a hemispheric initiative like the Free Trade for the Americas, and focus their analysis on the larger players. That kind of thinking, in this case, leads to the wrong analysis, as Central America has greater importance for the overall project than it seems at first, for at least three reasons: Central America is very open, has a network of bilateral agreements with other hemispheric partners, and manages the oldest and deepest subregional integration effort outside of the European Union.

Trade in Central America has an interesting demonstration effect that may permeate through the hemisphere. The Central American Common Market is, in my opinion, the most advanced of regional integration efforts in the hemisphere. For the past forty years the five Central American countries have had tariff-free trade among themselves in every product except sugar. Inter-Central American trade is at least 40 percent of the total trade for two of the Central American partners, and is more than 15 percent for each of the other partners. The applied most-favored-nation (MFN) tariff that non-regional products face when entering Central America is the same in every member nation for 93 percent of the tariff lines. This harmonization is genuine – something that, under closer inspection, is not the case for many products in the other subregional integration efforts in the hemisphere.

The Central American Common Market has for forty years had joint supranational institutions ruling over a variety of trade issues. We have negotiated together three free trade agreements, first with the Dominican Republic, then with Chile, and later with the United States. We are currently quite advanced in the preparation of negotiations with the European Union that will probably be taking place by early 2007.

The Common Market has not been a defensive mechanism, but rather an instrument to liberalize trade. Over the past two decades, the average external tariff has gone down from 100 percent to about 6 percent. There is now a commitment in Central America to tackling the tougher issues of economic integration. This will be more difficult, and probably will take longer than the timeframes that the Central American countries have proposed, but we are hoping that most of the reasons that justify the fact that we still have customs

offices and procedures between us can be eliminated within a decade. Our leaders say that it can be done in a shorter timeframe. Realistically, however, it will probably take a decade to move from complete most-favored-nation tariff harmonization among the five countries to transforming the border checks that currently take place between countries into the joint management and common standards essential for a much more integrated region.

An interesting issue to consider is how the subregional and bilateral trade agreements that Central America is engaged in relate to each other, and to the other economic integration efforts in the hemisphere. The Central American countries completed in 2004 joint negotiations for a free trade agreement with the United States (CAFTA), which has been implemented by five of the seven nations involved by mid-2006. Does CAFTA help or hinder Central American integration?

A positive answer to this question was one of the explicit objectives in the CAFTA negotiations. It does not always work out that way – especially when the sixth party in question is a country as big as the United States, which represents at least one-half of our non-Central American trade in each one of the five countries. Making certain that a joint free trade agreement with the United States will help rather than hinder Central American integration, and also improve the chances of a hemispheric deal, was not an easy task.

But CAFTA should help regional integration in Central America in several ways. First of all, the Central American Common Market, like many other regional integration efforts, has a lot of holes in it. It got started and had a lot of momentum for ten years, then three of the five members became engaged in civil war, one was taken over by a Communist government, and all five entered a long macroeconomic crisis. Consequently, we are a very advanced customs union in the kinds of things that were relevant topics back when the integration effort started, in the 1950s, and we are retarded in the kind of topics that have been more important recently, while we have been otherwise engaged. The fact that CAFTA applies multilaterally means that we can at least take what is in CAFTA and apply it among ourselves until there is something deeper. In those areas in which we have not managed to come to any agreement among ourselves, we can at least have the terms of the CAFTA from which to work. That is good progress.

The second reason is that the United States has accepted certain exceptions to most-favored-nation treatment regarding future progress within Central American integration. If the US had a right to every trade concession that the Central American countries make to each other in the interest of perfecting the common market, the size and competitiveness of the US would make it very difficult for those concessions to be granted. By accepting that MFN does not apply for the benefit of the US and the Dominican Republic in matters regarding the creation of a Central American Customs Union, a major obstacle is thus removed.

The third reason that CAFTA should be conducive to Central American integration is that, by having tariff phase-outs that converge roughly at the same time to zero for US–Central American trade, we reduce the difficulty of

nizing the MFN tariffs within Central America for the remaining 7 percent of tariff lines that are still different among us. Because the US is a relevant provider of most of the goods in that 7 percent, having a common tariff for those goods relative to our main trading partner much reduces the protectionist interests seeking disharmonization relative to other third parties. Also, since the rules of origin in CAFTA are regional rather than bilateral, there will be an incentive for processes in which different stages of production take place in different neighbors. In the Caribbean Basin Initiative and other tariff preferences that the US offers Central America currently, rules of origin are bilateral and much stricter.

Finally, perhaps the best way in which CAFTA helps Central American integration is the very fact that these five very diverse nations were able to negotiate jointly what will probably be their most important foreign agreement in years. In the negotiations there were a few topics that were understood to be bilateral, but everything that was supposed to be jointly negotiated was negotiated in this way until a common agreement was reached. That fact in itself bodes well for the Central American integration process. When we needed to agree with each other in order to face a larger counterpart, we did.

A reasonable next question is how Central American integration in particular, and bilateral agreements in general, lead to hemispheric integration. One hears a lot about "hub-and-spoke" trading arrangements, and about the "spaghetti bowl" of rules of origin when a nation is involved simultaneously in multiple regional and bilateral agreements. Some of that is true. Certainly it is the case that, on the blackboard, things always look easier to achieve from scratch.

Is the fact that Central America has its own internal integration process, and has in addition celebrated an agreement with the United States, something that helps or hinders eventual inter-American integration?

It certainly does not look like a hub-and-spoke arrangement from the perspective of the small countries participating in the process. For example, Costa Rica now has free trade agreements in negotiation or in place with twenty-five of the thirty-four FTAA countries that together account for 97 percent of its hemispheric trade. From our point of view, we are the hub. We have fairly deep, and fairly similar, free trade agreements with almost everybody in the hemisphere that desired one. We will be negotiating another FTA with the EU, by far the largest extra-hemispheric trading partner we have, pretty soon. These agreements make us closer, rather than farther, from global deep trade conditions.

You could say the same about a number of countries in the hemisphere. Is it easier to build inter-American integration upon a foundation that involves non-discrimination but does not make progress, or upon a foundation that involves some discrimination but also demonstrates some progress? Using the spaghetti-bowl analogy, making a homogeneous puree out of a bowl of spaghetti can be messy, but it is certainly easier than making a homogeneous puree out of an empty bowl, which is what we had before these free trade networks began. Just as the possibility of trade diversion caused by NAFTA became the incentive for many other nations to engage in further trade opening, CAFTA can also stimulate liberalization in the same way.

How CAFTA relates to hemispheric integration is important to me, personally, because I was among the group of thirty-four trade ministers who made the decisions that stalled, perhaps forever, the FTAA negotiations in November of 2003. What we did at the Miami meeting was very definitely a blow to at least the first impulse for FTAA. The countries that had really been pushing the initiative had to acknowledge at the time that the United States and MERCOSUR were no longer at the table. The two-tier plurilateral negotiating scheme that was then proposed as a solution killed the initiative, for in the past two years nothing has happened.

The idea of the two-tier mechanism was that there would be a common agreement for all parties, and then others that wanted to proceed further could do so. But in this hemisphere, the bottom tier is the WTO, and the top tier is the bilateral deals that various countries have negotiated. Thus, accepting the two-tier notion implied that further FTAA work would not yield valuable new results, at least for quite a while, and therefore negotiations stopped. We were not starting from nothing. We were starting from the forty or so agreements that were already in place. If the top tier does not need FTAA and the bottom tier does not need FTAA, the two-tier system means that there will be no FTAA.

We have to understand that the first impulse for the FTAA is dead, partly because the negotiations have taken too long. It was assumed that the political impulse we had in the beginning would last for ten years. However, the group of presidents that are in office today are a very different group from the group of presidents that launched the initiative ten years ago. And the initiative has faltered partly because the negotiations were allowed to turn into a negotiation between two countries, Brazil and the United States. Argentina and Brazil are among the largest economies in the hemisphere, and currently they do not have FTAs with most of the others. But by allowing the negotiations to turn into a negotiation between two countries and with thirty-two witnesses rather than having thirty-four countries negotiate, those that wanted the FTAA to move forward forfeited their greatest leverage. The leverage was that, even though Brazil and Argentina were big, if they could be made to feel isolated they would want to move ahead. That leverage disappeared after Miami. The political will to reach agreement just fizzled. Beyond a certain stage of the negotiations the protectionist elements in the business community become a minority interest and business becomes a force for liberalization. Momentum has been attained on the business side, but somehow the political will just disappeared.

Hemispheric integration will eventually happen, but in a different way. It will happen from the bottom up. The task now is to realize that we have five countries, which are about to become nine countries, that have bilaterals among themselves in every possible direction. While those bilaterals are not identical, and harmonizing the management of them will be complicated and difficult, they are better than having nothing to work from. It is important to harmonize these agreements, and also for agreements to allow accumulation of value added across these agreements to satisfy rules of origin. As we make progress within the five countries, soon to be nine, and eventually ten or twelve, those countries

that are actually serious about integration can approach the countries that have not yet decided whether they want to be in or not and present them with the agreed rules. They can be told that they are welcome to join or not, as they wish, but that they will not be interfering with the rules of the club, for these have already been determined. By advancing these little groups, and then trying to merge them together, a lot can be accomplished.

The kind of simplicity that we can get from hemispheric integration is something that cannot be achieved by promoting hub-and-spoke liberalization, even if each country considers itself the hub. Managing agreements that are not only different but also do not allow for the accumulation of origin is very complicated.

We are facing three political deadlocks for FTAA right now. First, so long as the WTO multilateral negotiations are stalled, that filters into the hemispheric negotiations. Countries may choose to fight for certain things in the WTO and others in the FTAA. Second, many countries are doing politics to promote trade, but other countries are using trade to promote their politics. The current governments of three of the largest parties, Brazil, Argentina, and Venezuela,[2] are at the very least tempted to do this. I have heard it said by trade negotiators of such reticent nations: “If this works out I am an economic hero in my country; if it does not work out, I am a political hero. So we are clear I am a hero, and here to determine what you are.” As long as those adverse incentives are there on the political side there will be trouble moving forward.

The third deadlock has to do with the way small nations can pursue trade liberalization. For most of them, besides their benefits from their own liberalization, a major incentive towards FTAA is market access to the US and Canada. At the same time, the largest political obstacle is local industry sensitivities to competing with Brazil and the other large Latin American economies. As a package, FTAA was saleable. If as time goes by we all keep making progress regarding integration among the smaller economies, and between them and Canada, while similar progress is not achieved relative to MERCOSUR, we will be pushed into a corner. Pushing hemispheric integration through an FTAA for a country that has already clinched the big prize – access to the North American market – and only has pending the challenge of competing with MERCOSUR may be very difficult politically. A way must be found around that deadlock.

To summarize, what Central America has achieved in the bilateral and subregionals level is interesting, and makes this region a very relevant component of the mix of economic and political forces that may eventually lead to FTAA. Recent progress in CAFTA and new projects in the Central American Customs Union would be a significant building block towards hemispheric integration. However, the future seems harsh for that integration, and what was agreed in the last ministerial meeting, in Miami, sadly implies that probably an FTAA created from top to bottom, as it was originally conceived, may never take place. We must pursue, instead, a bottom-to-top approach, where the building blocks of hemispheric integration are precisely the harmonization and origin accumulation across existing and new bilateral deals. Not all countries in the hemisphere may

want to participate in this, but at least the process would be shaped by those who want to be part of it in the end, and not by those who do not. Leadership, clarity, and the ability to overcome large political hurdles will be necessary for this; the rewards are equally immense.

Notes

1 This is a transcription of Professor Trejos' remarks during the conference, and not a contributed article.
2 Certainly this list has expanded since this speech was rendered.

8 MERCOSUR and the US

No finishing date

Felipe Frydman

Background

The initiative of the Free Trade of the Americas was launched at the First Summit of the Americas held in December 1994 in Miami, and was followed by the Denver Meeting of the Trade Ministers in June of the following year. Two big events were contemporaneous with this important decision to create a common market for 800 million people. These two events were the implementation of the NAFTA from 1 January 1994 and the birth of the World Trade Organization in April of the same year with the approval of the Uruguay Round Agreements in the Ministerial Conference of Marrakech. The old type of trade agreements, which covered only goods and some related issues, gave way to more comprehensive agreements where a much wider range of subjects were addressed: trade in goods, rules of origin, trade in services, intellectual property, limits to conditions imposed on foreign investment (TRIMS), phytosanitary issues, dispute settlement and some other minor ones. At the same time, the European Union was consolidating the common market, the ASEAN countries initiated their own process of integration, and in the southern cone of the continent MERCOSUR was busy with the construction of a common market. More open markets, competition and trade were at the center of all the international economic discussions.

The world was also celebrating the break-up of the Soviet Union into several national states and the adoption of the market economy by the Russian Federation. East Germany, which was the most advanced industrial economy of the East, joined the Republic of Germany. The Cold War was over, and with its end, the confrontation between east and west became part of the history books. The whole world was looking forward to new times of cooperation to face the problems of poverty still affecting the majority of the countries outside Europe and North America.

Together with the strong push for more open markets, the world was seeing a strong process of financial liberalization. Developing countries were opening their markets to short-term foreign financial capital in search of higher returns. There was strong competition for capturing foreign investment to propel domestic demand, and to finance both government deficits and the needs of the national private sector.

The Mexican financial crisis of November 1994, known as the Tequila Crisis, was classified as macroeconomic mismanagement of the political elite trying to hold on to power. The quick reaction of the United States Government in providing financial support to overcome the crisis was considered by all the countries of the region as a positive involvement. Most of the political leaders of Latin American governments interpreted this financial support as part of the accommodation of the US Government with NAFTA. Being part of a free trade area with the US was seen as also having the financial support that could boost the confidence of investors. The Clinton administration showed that it was ready to consider the problems of the region as part of its foreign policy, thereby strengthening its links with the Southern Hemisphere. A common language and vision existed between President Clinton and some of the main leaders of the region, especially President Fernando Enrique Cardozo of Brazil and President Patricio Alwyn of Chile. They were later invited to be part of the Third Way Initiative which tried to combine market economics with a social vision. Mexico had already signed the NAFTA and Argentina was a strong supporter of closer relationships with the US on all issues.

The Denver meeting of Western Hemisphere trade ministers stressed the need for an agreement that would be consistent with the provisions of the recently created World Trade Organization. This implied that it would be both balanced and comprehensive, covering all areas listed in the Miami Summit Document, and that all countries would adhere to all of the FTAA obligations. It was an ambitious outlook, having a common market from the northern tip of America to the extreme south of the hemisphere. The dream of the twentieth century had been to have a unified Western Hemisphere. The expression "America for the Americans and Europe for the Europeans" seemed to be coming true.

The increasing flow of foreign investment throughout the world was an incentive to ease barriers and facilitate trade. The technological revolution taking place in most sectors, but especially in telecommunications, electronics, and information technology, was reducing the physical distance among countries and creating the need for wider markets. The increased industrial productivity and the new flexibilities of the methods of production were symptoms of a new world economy, which at that moment were difficult to appreciate. However, they were going to have revolutionary effects on all the factors related to the changes in the international economy.

The whole idea of economic development during that time was centered on the possibility of attracting foreign investment. Economic policies were designed to provide the confidence and trust necessary to become an important recipient of foreign capital. More open markets and predictable exchange rates were the cornerstone of strategies to attract those flows of capital moving around the world looking for better opportunities.

Many of the leading ideas behind the Miami Declaration were soon put on trial when the chain of financial crises started to affect most of the developing countries throughout the different regions in one way or another. They had a strong impact in the biggest economies of Latin America, and this slowed down

the process of negotiations of the FTAA. These changes also affected the US Government, causing it to adopt a "wait and see" attitude rather than pushing ahead for an agreement. The efforts of the Clinton administration to get the approval of the NAFTA during 1993 were still echoing in both political parties.

The general crisis touching the developing countries in the second half of the 1990s had a strong impact on the whole process of negotiations. The financial crises, going from Russia to Korea, passing through Turkey, Indonesia, Malaysia, and from there to Brazil and later on to Argentina, raised an alert concerning the continuation of the policies of opening markets without taking into account the overall economic situation, including the financial changes in international markets. The first reaction to this type of crisis was to blame the incompetence of the leadership of every affected country, which even if it could be considered right, reveals the blindness or the collusion of all the others involved in designing those policies with their unforeseen problems. While the situation was responding to the flow of ideas coming from the main think tanks of the world, which were matched by the flow of incoming capital, it was easy to be the author of success. It is always more difficult to take responsibility for failures. The achievements of the 1990s lay with the international institutions, and the failures, of course, with the ineptitude of the political leaderships of developing countries!

The World Bank ratified later on (as always) the failures of the 1990s. The Study on Poverty Reduction and Growth says that Latin America's per capita GDP declined by 0.7 percent during the 1980s and increased by about 1.5 percent in the 1990s, with no significant changes in poverty levels. It says also that Latin America is the region with the widest income disparities, except for Sub-Saharan Africa. The people of Latin America had the perception, confirmed by empirical studies, that the process of reforms did not lead to higher growth and an improvement in living standards. This helps to explain the political changes that have taken place in several countries of the region during recent years.

A new situation

The last quarter of 2001 changed the way we looked at the world. The terrorist attack on September 11 shifted the priorities of the US Government, outlining a new political agenda where the problems with the fundamentalist groups of the Muslim world were placed at the top. Three months later, the WTO approved the starting of a new round of multilateral trade negotiations in Doha, Qatar, that included the issues of investment and competition policies. The Doha Statement was carefully crafted to show that, despite all the political problems, members were ready not only to work together but also to expand the scope of globalization. However, this time it was obvious from the Doha Statement that the emphasis would be placed on development, to quiet complaints of developing countries and get them involved in the process of negotiation. The Doha State-

ment was a compromise: there was the need to show unity and to go on strengthening the world economy in the face of the new threat.

The failure of progress of the FTAA negotiations from 2003 is part of the unfolding of all these events: political and economic changes which affected the perceived benefits of further liberalization. The free trade areas between developed and developing countries are supposed to include most of the issues governing the economic and trade relationship while moving deeper than the multilateral agreements. They have to move at least one step forward to justify the concessions that parties involved will grant each other in order to justify the elimination of barriers. Moreover, what it is more important is to be sure that the gains from these agreements will compensate for, or exceed, the losses that some of the sectors will inevitably suffer with more competition. As in the well-known phrase there needs to be a "win–win" situation.

Everybody favors the elimination of trade barriers from the standpoint of pure economic theory. Free trade areas in the old and new versions are also favored, and they constitute a useful tool to promote growth and welfare for the people of the countries involved. If this were always true, the negotiations could be very easy. But the real world comes with a history and with an unequal distribution of endowments, which have been analyzed in multiple ways and led to the famous comparative advantage theorems. This part of the theory lost importance in Latin American during the 1960s or 1970s in favor of the structuralist theories, but it seems to have reappeared again with this new phase of globalization.

The changes of production methods and the enormous increases in productivity that they brought about were revolutionary and made it possible to initiate a new stage in the process of globalization. During the 1980s, but mainly during the 1990s, there was an extraordinary change in the distribution of industries throughout the world and an important increase in foreign trade of parts and services within the multinational companies. International trade started to have a larger participation in GDP, and services became the main productive sector in developed countries as they left behind the agricultural and industrial sectors. Factories from the US, Europe and Japan that were relatively labor intensive moved out to developing countries to take advantage of cheaper costs of production and, additionally, to get a foothold in domestic markets, which was up to that time the main justification for foreign investment. It would have been unthinkable to move steel and petrochemical plants around the world in a short period, but the 1990s were also witnessing the birth of new types of industries that could easily be transferred from one country to another. Comparing the largest 1,000 companies in the world in 1970 with the listing in the year 2000 demonstrates the changes occurring in the world economy.

The political and cultural layers of societies require time to perceive the changes in the level of the economic structure. While production is becoming internationalized and new industries are being developed, countries are still relying on old decision systems which put more emphasis on surviving than on the possibility of moving forward. Societies are composed of diverse levels,

which respond to outside stimuli at divergent speeds. This is why changes are so difficult to incorporate; they have to overcome the resistance generated by the changes. Even when enlightened people know how positive those changes could be for the development of society, there are still many who will be very resistant to reforms. This interpretation describes the process by which economic progress of societies takes place. The history of mankind could be written as the confrontation between the old and the new. While the old guard fights to stay on and keep its benefits, the new has to battle to provide a place for a new generation which can make more appropriate decisions.

The multilateral agenda

In September 2003, the WTO Ministerial Conference of Cancun failed. There was no progress toward an agreement that would lead to more open markets. Moreover, the new issues of investment regulation and competition policy were dropped from the agenda. Most of the countries, both developed and developing, rejected the possibilities of establishing multilateral rules to govern their decisions on sensitive issues that were closely related to their domestic policies. The US and some developing countries resisted the idea of continuing the discussions without knowing where they would end. The EU decided that those issues were not its concern, and the US showed no interest in continuing discussions that could jeopardize its decision-making policy on foreign investment. The failure of the negotiations for a Multilateral Investment Agreement (MIA) in 1998 among developed countries weighed heavily in this decision. It is also important to remember that developed countries refused to grant unconditional most-favored-nation (MFN) treatment in an agreement of this type, while at the same time they requested exactly that of developing countries.

The FTAA negotiations followed a parallel line with the multilateral negotiations. However, the discussions are held in different ways. In multilateral negotiations the parties have to reach a consensus, and small and big countries are equal. During the negotiations for a free trade area, developed and developing countries confront a completely different situation. The markets of developing countries account for only a small percentage of the exports of the larger developed countries, whereas the larger developed countries typically account for a much larger percentage of the exports of less developed countries. This is clearly the case in the relationship between the US and most of the Latin American countries. The US can easily dictate the terms of the negotiations when it comes to discussing market access.

In the FTAA negotiations, the US delegation had a clear mandate to avoid the possibility of discussing the issues most important to the MERCOSUR countries, namely, domestic and export subsidies and market access for agricultural products. It just happens that MERCOSUR countries have their economies based in the agricultural sector, and such products represent a larger percentage of their exports. The US systematically insisted on the necessity of discussing those issues at the multilateral level where it confronts its agricultural policy

with the European Union. It is not difficult to understand why the US Congress would not relinquish its decision-making in agriculture in exchange for an agreement with the MERCOSUR countries, since these countries represent a small percentage of total US exports.

The Uruguay Round Agreement on Agriculture legalized the subsidies given by the main developed countries to protect their declining number of farmers. It is true that the Uruguay Round brought into the WTO the discussion on agricultural subsidies that had been excluded until then. However, it legalized one set of rules for industrial products and another for agricultural products. While industrial products were to be traded without subsidies of any type, agricultural products retained the highest import tariffs and the most important ones continue to be subsidized. The US spends $20 billion to subsidize domestic production of agricultural products and applies an intricate mechanism through credits and food aid to push its exports. The result of this policy is the reduction of international prices and unfair competition with other agricultural producers, and also protection for US farmers in the domestic market. The case of subsidies for the production of cotton is a clear example of the way that a big country was able to manipulate unauthorized programs to assist its farmers. This situation was confirmed by decisions rendered by WTO dispute settlement panels after four years of complaints and denials.

The MERCOSUR–US negotiations

During the FTAA negotiations, the US pressed MERCOSUR countries to obtain a TRIPS-plus agreement, opening new sectors for investment and reduction of the industrial tariffs. The US tried to obtain what could be referred as a one-sided free trade area, repeating at the bilateral level what the GATT has done since its origins – that is, more open markets where developed countries are efficient, and closed or restricted markets where they cannot compete with the production originating in developing countries.

In all negotiations, countries should prepare a balance sheet to calculate the results. MERCOSUR was not getting much in return. It was being asked to open its markets to US industrial products while being unable to obtain similar concessions from the US for its agricultural products. This was an inequitable deal. The US domestic subsidies were an impediment to increased agricultural exports to the US market, and US export subsidies were unfair competition for MERCOSUR's products in other Latin American markets. The US market is one of the more open markets, except for dairy products, peanuts, citrus, beef, tobacco and sugar. It also has domestic subsidies for wheat, maize and soybean production. Furthermore, the US and MERCOSUR countries are competitors in the international market for all these products.

Nevertheless, an important, and perhaps *the* most important, issue with free trade agreements for developing countries is the possibility of attracting foreign investment. With MFN for investment and no barriers to trade, US factories could move to developing countries to take advantage of new market opportunities in

those countries, and also to reduce production costs for export back to the US. The history of NAFTA shows the big inducement to engage developing countries in the FTAA negotiations. As a result of NAFTA, factories from all over the world moved to the "maquilas zones" where they found cheap labor. This allowed them to overcome US import barriers to the automobile industry (Reagan's trade restrictions) and, in the case of US companies, to reduce costs in order to compete better with Japanese products.

The international situation has since completely changed. The entrance of China into the WTO in December 2001, the granting of GSP benefits by the US, and the awakening of India to the world economy have signaled an end to the flow of productive capital because of slight changes in import tariffs. US tariffs on industrial products are quite low, and their gradual elimination does not constitute enough of an incentive to attract foreign investment. China has not signed any free trade agreement with the US or with Europe, and has become the largest recipient of foreign investment, looking mainly to export back to those markets with access to the huge domestic market as a secondary goal. This example has become crucial to free trade negotiations.

MERCOSUR cannot expect to compete with the same type of Chinese exports. China still has an unlimited number of peasants ready to become industrial workers to escape the hardships of a backward rural lifestyle. Regardless of how much money they will make, it will always be higher than the salaries they received working on the farms. The supply of people could prevent any increase of wages in the labor-intensive sectors for many years. Mexico is losing its comparative advantages (cheap labor) even though it is closer to the US and has minimal freight and administrative costs. In order to receive foreign investment, countries should have some comparative advantage that can justify the moving of an assembly plant to another country. MERCOSUR has without any doubt comparative advantages in the production of agriculture commodities, raw materials, and minerals that provide inputs for the final consumption sectors such as the food industry, steel, petrochemicals, and others. These are the sectors where the US is still not ready to make concessions to facilitate trade due to the strong resistance of interest groups.

Investments in programming, high-tech or call centers do not need any special free trade arrangements. The countries that are becoming leaders in these areas are India, Ireland and the Philippines. They do not have free trade agreements with the US or Japan. They have received these investments because they have an edge in mastering the language, have highly educated professionals, and offer big tax breaks. The information flows through the broadband cables and does not need to go through customs and pay import tariffs.

Another contentious issue is intellectual property rights (IPR), where the US is insisting on assuring longer periods for patents and is limiting the possibility of producing generic drugs through an interpretation of Article 39.9 of the TRIPS which refers to data exclusivity. MERCOSUR grants protection according to TRIPS, and no foreign company has challenged the implementation of this agreement in a national court. The USTR has not taken any of the Latin

American countries to the WTO regarding this issue. In the new FTAs, the US wants to assure that developing countries should follow procedures similar to the US Patent Office and compensate the pharmaceutical companies for the difference in the required time for approval.

The USTR also wants to include, as being subject to patents, the procedures for diagnostic, therapeutic and surgical procedures for the treatment of humans or animals. In addition, the US contends that new patents should also be available for any new use or method of a known product, which is also a way of extending the validity of an already granted patent and restricting the possibilities of manufacturing generics.

Patents are equivalent to having monopoly power to fix the price and cannot be contested in courts. Nobody disputes the right of companies to obtain a profit in return for their investments in genuine research and development of new products. However, because patents provide companies a monopoly position, governments should be able to assure people that they will have access to potentially life-saving products.

The cost of changes in the patent laws should also be considered carefully. The costs of health programs, private or national, are increasing because of aging populations and higher prices of drugs. New concessions will add to budgets, and governments or families will not be able to afford them. The US has long experience with this issue.

The changes in the international situation have blocked the possibilities of engaging MERCOSUR and the US in a serious negotiation where everybody could make concessions in support of a tangible free trade area. The negotiations on CAFTA were a clear signal that there is no sentiment in the US Congress to proceed with an exercise of expanding NAFTA to incorporate big economies. The idea of an FTAA could be very attractive, but it should have an economic meaning for MERCOSUR. Given the situation in the US today it is almost impossible for it to make concessions on sensitive issues – which are essential if MERCOSUR is to pursue the negotiations.

FTAA should mean an increase in trade and investment in favor of developing countries to help them to enter a new phase of growth. Large countries should look into these agreements not only with a dollar sign in their eyes but also with a political interest in diminishing the relative difference with developing countries and promoting a reduction in poverty levels. The whole idea of the 1990s, that free trade by itself could improve economic performance, has "gone with the wind" because, in practical terms, the advice was only given to developing countries. Developed countries fight very hard to keep their prerogatives in the negotiations, and have a different language when it comes to discussing the meaning of protection not only in trade but also in investment. If the understanding of the discussions of a free trade area sometimes becomes clouded because of the complexities of the texts involved, or because it becomes difficult to get public opinion involved without ideological intolerance, the discussions at the WTO are without any doubt a clear example of the double standards used by the US, the EU and Japan.

As the position stands today, very few possibilities exist for reaching a comprehensive agreement that could justify engaging in the FTAA negotiation. Every party wants to go back and justify what it has reached in the course of so many years employed in the discussions. It is true that results are difficult to measure quantitatively because there are many intangible issues, but at least it is necessary that they provide an orientation to the different constituencies. It cannot be, as it was in the 1990s, approved in the name of providing stability and improving the institutional framework, trying to replace from the outside what cannot be reached from inside.

MERCOSUR needs a true opening of the US market to its products to create, at the end of the road, a free trade area without subsidies that recognizes the special and differential treatment for developing countries. The quotas negotiated by the US with Australia, Chile or CAFTA will not be acceptable in an agreement with MERCOSUR. Those countries have dissimilar economic interests and different export structures. MERCOSUR cannot be compared to them.

The US is losing a great political opportunity to show leadership in Latin America. Caught up in the quest for immediate gains, the US negotiators lost the longer view and did not realize what their country could potentially contribute to assure democracy, human rights, peace and development throughout the continent. The US negotiators belong to a bureaucratic institution pressured by thousands of lobbyists who work day and night in favor of some enterprises. They flood the USTR with reports of all kinds, which cannot be processed or checked considering the current staffing levels of this department. These lobbyists are also filling the mailboxes of the congressional representatives, demanding results now in exchange for later contributions to more and more expensive electoral campaigns.

The US Government does not have institutions that are capable of designing a long-term strategy towards Latin America. The future of the US does not lie with the sugar, avocados, tomatoes, lemons and peanuts – products which at one time needed slave labor and now promote illegal immigration and higher subsidies. They are remnant sectors of the nineteenth century that a modern economy cannot sustain without subsidies paid by the taxes of all society.

Not long ago, a US congressman expressed in a public hearing his concerns about the unemployment problem in his constituency because of the growing outsourcing, and asked the Chairman of the Federal Reserve his views on this issue. The US unemployment rate was at that time 4.7 percent, one of the lowest in many decades. If the political leaders of the US have this interpretation of the economic situation of the world, there is little prospect that developing countries can hope to achieve fair results in any trade negotiations with that country.

9 The Caribbean Community

Integration among small states

Anneke Jessen[1]

For decades, the constraints of small size, a common history and certain cultural affinities have combined with external pressures to push Caribbean countries towards ever-closer regional integration. Today, the Caribbean Community (CARICOM) is one of the most advanced integration arrangements in the Western Hemisphere. It is the largest in terms of membership, yet by far the smallest in economic size. At $40 billion, the group's GDP is barely half that of Colombia or Peru. Twelve of its fifteen members are island economies separated from each other by the Caribbean Sea, one forms part of the Central American isthmus, and two are on the South American continent. While all fifteen participate in the Community's foreign policy coordination and functional cooperation efforts, only twelve members have joined the group's common market arrangements; seven of them already have a monetary union among themselves. The group, moreover, comprises some of the richest and some of the poorest countries in the hemisphere. These characteristics make CARICOM unique among the various integration groups in the region, and present unique challenges for its integration process.

This paper reviews recent developments in CARICOM's regional integration process, assesses the current status of that process and discusses the main challenges facing Caribbean countries as they move towards deeper integration.[2] Its main focus is on economic integration, although it also briefly reviews the group's foreign policy coordination and functional cooperation efforts, which are more advanced than those of other integration groups in the hemisphere. For Caribbean countries, regional integration is not an end in itself, but one of several policy instruments they use to achieve their development goals. According to Chapter I of the CARICOM Treaty, these goals include accelerated and sustained economic development through increased productivity, higher levels of international competitiveness and expansion of economic relations with third countries; and more efficient operation of health, education and other social services. Caribbean countries recognize that successful participation in the global economy is crucial for their sustained economic development, and have increasingly sought to shape their integration process to reflect that goal. As the paper nevertheless argues, more sustained efforts to deepen the existing integration

arrangements are needed to make CARICOM a truly effective instrument of global integration, competitiveness and economic growth for its member states.

From free trade area to single market

CARICOM was established in 1973 with three core objectives: to foster economic integration among its member states through the creation of a common market; to strengthen the region's external position through coordination of member states' foreign policies; and to pool resources through functional cooperation in areas such as health, education and disaster risk management. Barbados, Guyana, Jamaica, and Trinidad and Tobago were the founding members of CARICOM. In 1974 they were joined by Belize and seven Eastern Caribbean island states, which in 1981 created their own integration group within CARICOM, the Organization of Eastern Caribbean States (OECS).[3] The Bahamas joined CARICOM in 1983, Suriname joined in 1995 and Haiti in 2002.

Despite the stated aim of a common market, CARICOM's founding treaty did not cover all issues pertinent to achieving that goal. Instead, it focused mainly on the initial stages of integration, namely the creation of a free trade area in goods and the implementation of a common external tariff (CET). Similar to other integration groups in the Western Hemisphere, CARICOM countries initially pursued a rather inward-looking, protectionist integration agenda, aimed at boosting regional production sharing and the development of local industries behind a protective wall of high import tariffs. While intra-regional goods trade was liberalized early on, implementation of the CET was postponed on various occasions and was not completed until a few years ago.

Following a period of stagnation, CARICOM members took concrete steps in the late 1980s to revitalize their regional integration process, adopting a more outward-oriented approach to integration. In the 1989 *Declaration of Grand Anse*, they reaffirmed and broadened the Community's core objectives to include the creation of a CARICOM Single Market and Economy (CSME). Apart from free trade in goods and a common external trade policy, the single market was to comprise the free movement of services, capital and skilled persons across the region and the right of CARICOM nationals to establish a business presence anywhere in the region without restrictions. The single economy referred to macroeconomic policy coordination, harmonization of national laws and regulations in key areas of the economy, and common sector policies.

Above anything else, Caribbean countries view economic integration as a way to mitigate the vulnerabilities of small size. The rationale for the single market is that it will facilitate a more efficient allocation of resources and, thus, more competitive production of goods and services in the region. Macroeconomic coordination and the harmonization of economic policies and regulatory systems are expected to boost the gains from intra-regional liberalization and encourage domestic and foreign direct investment in the enlarged regional

market. Size constraints have also driven the group's foreign policy coordination. While the Caribbean countries have little international bargaining power on their own, together their voice is stronger. With very small public administrations (in absolute rather than relative terms), individual countries moreover lack sufficient resources to conduct effective international diplomacy and negotiations. By pooling those resources across the region, CARICOM countries believe they are in a better position to respond to external challenges and to negotiate with third countries. A similar logic underlies functional cooperation, where countries hope to achieve both cost savings and quality enhancements in the common provision of social services.

During the 1990s, CARICOM countries gradually revised their original treaty to establish the legal basis for the CSME. This process took longer than anticipated, as did the subsequent implementation of the treaty's core single market provisions. In the last five years, however, progress has been quite significant. In 2002, twelve countries (the CSME-12, see Box 9.1) signed the Revised CARICOM Treaty.[4] Since then, all twelve have ratified the treaty, eleven have enacted it into domestic law, and its full implementation is now a priority. In 2004, member states inaugurated the Caribbean Court of Justice (CCJ) to oversee the implementation and correct application of the treaty. In 2005, Suriname was the first country to issue a CARICOM passport; four countries have since followed suit, and the remaining ones plan to do so within the next year. In June 2006, Barbados, Belize, Guyana, Jamaica, Suriname, and Trinidad and Tobago signed a declaration marking the entry into force of the CARICOM Single Market. OECS countries signed the declaration six months later. A Regional Development Fund to assist disadvantaged countries, regions and sectors with CSME-related adjustment is expected to become operational in 2007. As the single market takes shape, member states are increasingly shifting their attention to issues related to the single economy. Despite such progress, however, much remains to be done to achieve a fully integrated regional market.

Box 9.1 CARICOM, CSME and OECS – varying levels of integration

CARICOM: CSME-12 plus The Bahamas, Montserrat and Haiti. All CARICOM members participate in foreign policy coordination and functional cooperation, although Montserrat's participation in the former is constrained by its status as dependent territory of the United Kingdom. Haiti has not yet signed the Revised CARICOM Treaty. It was excluded from Community decision-making bodies during most of 2004–2005, but re-joined the group following its national elections in 2006.

CSME-12: Barbados, Belize, Guyana, Jamaica, Suriname and Trinidad and Tobago, plus OECS-6. These countries belong to the CSME. The Bahamas has never participated in CARICOM's economic integration efforts. Haiti is expected to join the CSME at some point in the near future. Montserrat also plans to join and is awaiting entrustment from the UK to this effect.

OECS: Monetary union comprising Antigua and Barbuda, Dominica, Grenada, St Kitts and Nevis, St Lucia, and St Vincent and the Grenadines (OECS-6) plus the dependent territories of Montserrat and Anguilla. This is the deepest form of economic integration within CARICOM.

Pending issues in the implementation of the single market

Although the CARICOM Single Market has formally entered into force in twelve countries, it is not yet a true single market as traditionally defined in the economic literature. Gaps remain even in the most advanced area of the single market, the Community regime for trade in goods. Although intra-regional trade is virtually free of tariff restrictions and most unauthorized non-tariff barriers have been lifted, the widespread and disparate use of authorized measures such as customs surcharges or stamp duties is constraining trade. Apart from remaining tariff and non-tariff restrictions, some further issues will moreover need to be resolved to fully attain the free movement of goods. First, there is no agreement yet on how to treat goods produced in and shipped from free trade zones within the region. Second, CARICOM does not yet have a regime for free circulation. Currently, extra-regional suppliers face border restrictions both at the point of entry into the single market and each time goods that are not of Community origin are re-exported within the CSME. This complicates intra-group trade and hinders the creation of cost-saving distribution hubs in the region. Third, members have yet to develop a common regime for government procurement – which constitutes a significant share of the regional market for goods and services – and electronic commerce. Technical work is underway in all these areas, but specific policies and related legal and administrative arrangements have not yet been agreed.

The common external tariff, implemented during the 1990s, has brought import tariffs down from an average 20 percent in the early 1990s to around 10 percent today. All CSME members except St Kitts and Nevis currently apply the CET. St Kitts and Nevis still has to complete the final phase of tariff reductions, while Haiti and The Bahamas continue to retain their own tariff systems. Haiti's external tariffs are on average much lower than those of the CSME members, and it is not clear how this issue will be solved when Haiti joins the single market. In contrast, import tariffs in The Bahamas, which does not participate in CARICOM's economic integration arrangements, mostly exceed those of the CET by a large margin.[5]

The CET has some problems that will persist even when it is fully implemented throughout CARICOM. First, the regime is not really common because it offers broad scope for national exceptions and derogations from the common tariff (Figure 9.1). This complicates the region's joint negotiating efforts with third countries and, given the implementation of rules of origin to avoid trade deflection, creates additional transaction costs for exporters targeting the Caribbean market. Second, the level of tariff dispersion in the CET structure remains high, resulting in additional efficiency costs. Third, while considerably lower than a decade ago, CARICOM tariffs are still relatively high, particularly

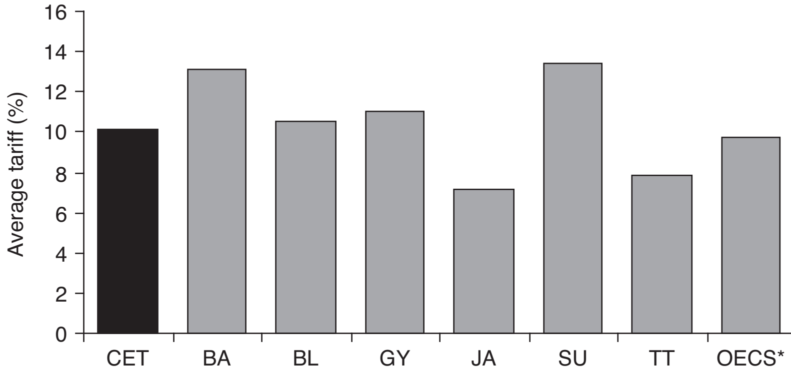

Figure 9.1 CARICOM CET and national applied tariffs of CSME members (source: IDB Integration and Regional Programs Department, using FTAA Hemispheric Database for CET, and UNCTAD – TRAINS for national applied tariffs).

Notes
Calculations based on tariffs applied in 2003.
*OECS represents an average of the six countries' applied tariffs.

in the food and manufacturing sectors. This raises concerns about trade diversion and is not conducive to the development of internationally competitive local industries. Most governments recognize the need for reform of the CET and the accompanying rules of origin regime, but are concerned about revenue implications of further tariff reductions.

Right of establishment and the free movement of services, capital and people are crucial steps in strengthening the region's international competitiveness, and comprise a cornerstone of the single market. Chapter III of the Revised CARICOM Treaty, which governs these four areas, entered into force on a provisional basis in 1998. It includes a "stand still" obligation (member states may not introduce any new restriction affecting these areas) and calls on member states to establish a program for the removal of existing restrictions within a year. This timetable had to be modified because the process of identifying and notifying restrictions took much longer than anticipated. The program was finally agreed in 2002 and implemented in the following four years, except for a few pending items that some countries still have to address (CARICOM Secretariat, 2004a).

Along with the common regime for trade in goods, Chapter III provisions as reflected in the 2002 schedule constitute the "core provisions" of the single market. However, even when the schedule is fully implemented in all member states, CARICOM will not be a true single market. First, exceptions to the right of establishment and full factor mobility will remain.[6] Second, member states can seek exemptions from their Chapter III obligations by applying Chapter VII provisions designed to shield vulnerable sectors of the economy from full intra-regional competition.[7] Third, some administrative processes linked to the single market still need to be put in place.[8] Fourth, some sectors remain

excluded from liberalization because common provisions have not yet been agreed or because full liberalization is not contemplated. For example, member states have yet to develop common provisions for air and maritime transport services, which are of crucial importance to the operation of the single market. More importantly, perhaps, the free movement of people is restricted to some categories of skilled professionals and their families, barring others from enjoying similar rights (see Box 9.2). Partial liberalization constrains the effective allocation of resources across the region and may intensify adjustment costs from intra-regional liberalization; it may also be less cost-effective from an administrative point of view (Mesquita Moreira and Mendoza, 2006).

Box 9.2 Free movement of people – not so free

Eleven countries have implemented legislation and the regulatory and administrative arrangements needed for the free movement of university graduates, artists, media workers, sports persons and musicians. Two OECS countries still need to fulfill their obligations in these areas. CARICOM leaders have recently announced their intention to expand the categories of skilled nationals with the right of free movement beyond the five aforementioned professions. In addition, the provisions on right of establishment contained in the treaty accord free movement to self-employed service providers, entrepreneurs, technical, managerial and supervisory staff, as well as their immediate family. Only six member states have so far passed legislation to give effect to this extension of free movement; the remaining (OECS) countries are expected to do so by the end of 2006.

Even in its more limited form, this aspect of the single market is one of the most controversial, especially in the current context of high unemployment across the region. The fear of being "inundated" by migrants from other Caribbean countries partly explains why the Bahamas has not joined the single market; similar fears are prevalent in several other countries. Full labor mobility, and thus a true "common market", is unlikely to be achieved in the near future, given the reluctance among member states to liberalize the movement of unskilled labor. This is unfortunate, since greater factor mobility could yield important economic benefits for the Community.

Real flows: how integrated are the Caribbean economies?

For CARICOM as a whole, the share of intra-regional trade in total merchandise trade is not significant, understandably so given the limited size of the regional market. On the export side, the share has fluctuated considerably over the years, strongly influenced by Trinidad and Tobago's export performance in both regional and extra-regional markets. Between 1994 and 1999, CARICOM's intra-regional exports grew much faster than its extra-regional exports, and their

share in total exports rose from 13 percent to 18 percent. Between 1999 and 2004, however, the opposite occurred, and the share dropped back to 12 percent, a result of both stagnant growth in intra-group trade and strong growth in Trinidad and Tobago's energy exports to extra-regional markets. Excluding Trinidad and Tobago, the share of intra-regional exports in CARICOM's total exports has remained more or less stable at around 10 percent throughout the period examined. The regional averages mask huge variations in shares across countries (Figure 9.2).[9] Growth in intra-group trade has also varied across the region, averaging 8 percent a year for CARICOM as a whole. Most of this growth occurred in the late 1990s, and in the past five years such trade has barely grown (Figure 9.3). Despite lower levels of external protection resulting from the new CET, the share of intra-regional imports in the group's total imports remained constant at around 11 percent during the period examined.

Intra-regional merchandise trade is dominated by Trinidad and Tobago, which accounts for almost 70 percent of all intra-group exports. Its exports to the regional market have grown consistently over the last decade, and its market share has increased in virtually all of the group's countries. Few other CARICOM countries have managed to increase their share of the regional market, and some have lost market share in recent years. The product composition of intra-regional trade is strongly influenced by Trinidad and Tobago's exports to the region, with fuel products accounting for half of all such trade. Food and manufacturing products account for most of the remaining exports, and are the main export items sold by all other CARICOM countries in the regional market. The product composition of intra-regional trade shows that such trade is not very diversified and that countries have not exploited their preferences to upgrade their export supply by advancing from less complex products to more sophisticated goods with higher technology content. In 2004, twenty products alone accounted for 64 percent of total intra-regional exports in value terms, and 90 percent of intra-regional exports were either primary products, resource-based or low-technology manufactures.[10]

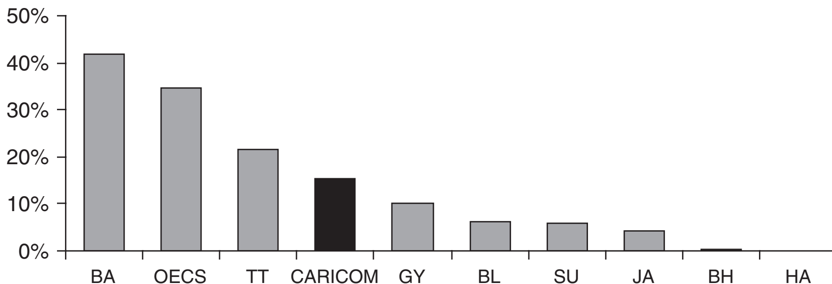

Figure 9.2 Importance of the regional market: Share of intra-regional exports in total merchandise exports, 1994–2004 (source: IDB Integration and Regional Programs Department, based on UN COMTRADE, IMF-DOTS, WTO, IMF-BOPS, ECLAC and CARICOM Secretariat).

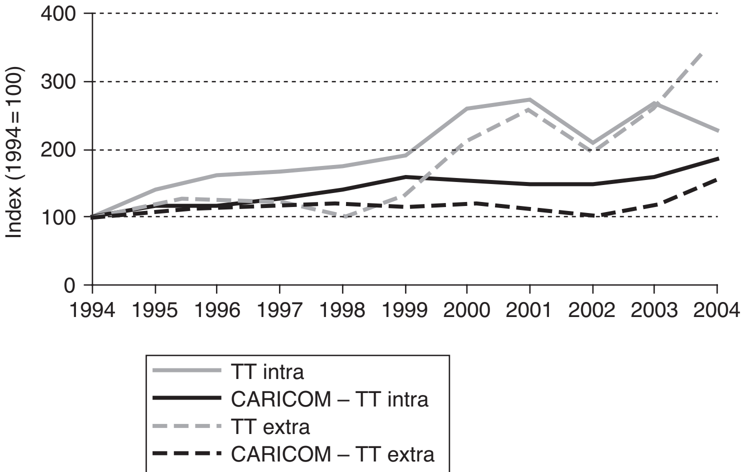

Figure 9.3 Growth in intra- and extra-regional merchandise exports, 1994–2004 (source: IDB Integration and Regional Programs Department, using UN, IMF, WTO and CARICOM data).

Removing the remaining restrictions to intra-regional merchandise trade would certainly facilitate such trade, as would more efficient transport systems across the region. However, given the small size of the regional market, such trade will never constitute a large share of CARICOM's total trade. That is why the objectives of Caribbean economic integration go well beyond facilitating intra-regional trade. The main goal is to strengthen the region's position in external markets through full implementation of the CSME.

CARICOM lacks detailed statistics on the group's intra-regional services trade. Anecdotal evidence nevertheless suggests that such trade has grown significantly in recent years, predominantly through direct investment in industries such as finance, insurance, tourism, retail, business and entertainment services.[11] Full implementation of all treaty provisions on commercial presence and movement of persons within the Community would further facilitate what is already a real economic trend in the region.

Capital markets are still fairly fragmented in the region. National stock exchanges exist in The Bahamas, Barbados, Guyana, Jamaica, Suriname, Trinidad and Tobago and the OECS, but cross-listing and trading takes place only among three of them. The extent of such cross-listing is moreover very low. A Regional Capital Markets Committee, working closely with CARICOM's Ministerial Council for Finance and Planning, has been developing recommendations for the creation of a regional stock exchange, but a final decision on this is still pending. To facilitate greater capital market integration, member states have agreed to develop a CARICOM Financial Services Agreement, which would help streamline the cross-border operations of financial institutions, reduce barriers to cross-border financial flows while ensuring

transparency with respect to rules and regulations, and advance the system towards international best practice standards (CARICOM Secretariat, 2004b). The agreement has already been drafted, but the consultation process is still underway. Meanwhile, the establishment in 2004 of a Caribbean Regional Credit Rating Agency (CARICRIS) in Trinidad and Tobago is expected to accelerate integration of the regional securities industry.

There are few data on the movement of skilled professionals in the region. According to some observers, the numbers are quite small. Remaining restrictions and cumbersome administrative processes often make it unattractive for people, especially those with families, to move. Full implementation of all treaty provisions and related administrative arrangements is nevertheless expected to lead to greater mobility. Curiously, anecdotal evidence suggests that unskilled labor is moving across the region more frequently and in greater numbers than skilled labor. Such movement, however, is illegal, and thus not accompanied by facilitating measures such as transferability of social security benefits or health insurance; it is both costly and risky for those involved, and contributes to the problems associated with a growing informal sector in CARICOM.

Towards a single economy

There is some uncertainty surrounding the “E” in the CSME. In 1992, government leaders established monetary union – already in effect among the OECS countries – as an explicit goal of the Community, to be achieved through a staged process of monetary convergence. This goal was later abandoned, at least for the foreseeable future. Today, “single economy” mostly refers to a less ambitious form of integration, namely macroeconomic coordination, harmonization or convergence of national policies, laws and regulations in various economic areas, and implementation of common sector programs. While some accept this definition, others argue that a single economy with nine different currencies is a contradiction in terms, and that it must, by definition, include monetary union. Another uncertainty surrounding the single economy is its implementation timetable. Regional leaders plan to establish a “framework” for the single economy by 2008, but what exactly this means is not clear. For many aspects of the single economy, there is no detailed implementation plan, nor a clear definition of what needs to be implemented. This, then, remains a crucial yet little defined and barely implemented component of the CSME.

To date, macroeconomic coordination has consisted of a loose institutional arrangement in the form of periodic meetings of CARICOM finance ministers and central bank governors. More binding rules and procedures for policy coordination and implementation are not yet in place. To facilitate coordination, the Caribbean Centre for Monetary Studies (CCMS) prepares semi-annual reports on the performance and convergence of CARICOM economies. To measure convergence, the CCMS tracks performance on a set of five eligibility criteria for entry into a monetary union: reserves (import cover), exchange rate stability, debt service, fiscal deficits and inflation rates. Member states do not

appear to have integrated the convergence criteria into their budgetary and policy-making processes, and there are no agreed mechanisms to correct underperformance. The continued and sometimes substantial dispersion in performance for most indicators suggests that convergence is not taking place. Underlying the divergences are big structural differences, giving rise to wide disparities in wage rates, interest rates and debt–service ratios. The maintenance of different exchange rate regimes across CARICOM is a major obstacle to greater convergence.[12] Clearly, the conditions for greater convergence in the short to medium term – and the eventual creation of a monetary union – are not yet in place.

Harmonization of national laws, regulations and administrative practices in key areas of the regional economy could bring sizeable efficiency gains for CARICOM, but implementation to date has been slow and there is some uncertainty about the scope and timing of regional initiatives in this area. Harmonization is contemplated in a variety of areas, including fiscal and investment policies, customs, intellectual property rights, standards and technical regulations, labeling of food and drugs, sanitary and phytosanitary measures, companies, competition policy, consumer protection, banking and securities legislation, and commercial arbitration (CARICOM, 2001).

Harmonization of fiscal and investment policies is particularly important for the operation of the single market. Technical work is underway in several areas of fiscal policy, but countries have yet to agree on a policy framework and guidelines for harmonization. Similar tax structures across the region should facilitate harmonization, but the wide use of tax exemptions and other exceptions in national tax regimes could complicate the process. In the area of investment policy, CARICOM is in the process of developing a Regional Investment Code and a harmonized system of investment incentives to which all member states could commit. There is no agreement yet on the precise nature of such a system, although experts in this area have put forward a number of recommendations. Prior experience with a common incentive regime, adopted in 1973 but never fully applied, raises some doubts about whether progress can be achieved in the short term. Progress is nevertheless vital in order to increase transparency for investors and contain the harmful tax competition that occurs among countries as they seek to attract foreign investment to their territories.

As regards common sector programs, the CARICOM Treaty calls on member states to promote, cooperate, collaborate and coordinate actions in the areas of agriculture, transport and industrial policy, including micro- and small enterprise development, services and tourism. Many of the proposed activities in the treaty have not yet been defined in detail and, in most sectors, common initiatives have barely moved beyond the creation of working groups, initiation of technical work and some policy debate. Progress has been constrained by a lack of technical, human and financial resources and, in some cases, weak political will at the national level.

Of all the sectors highlighted in the treaty, transport is perhaps the one requiring most urgent attention, not only because improvements in this sector would

benefit all other economic sectors in CARICOM, but also because regulatory harmonization, mechanisms for regional oversight, and resource pooling in the provision of transport infrastructure and services could bring sizeable cost-savings for national governments. The link between transport efficiency and competitiveness is particularly evident for Caribbean economies, since their small size and openness make them highly dependent on trade for economic growth. Their island geography, remote location and/or size constraints make transport costs a significant factor in determining the competitiveness of tradable goods and services produced in the region, especially tourism. The free movement of skilled persons across the region also demands efficient, hassle-free travel to realize the full potential of the single market.

In the air transport sector, poor access to international traffic as a result of poor hub facilitation, and the failure to consolidate intra-regional air traffic, which is handled by a number of small, unprofitable regional airlines, constrain tourism growth and intra-regional travel (Bertrand, 2006). Maritime transport services suffer from weak regulatory structures and limited and costly shipping connectivity. The absence of a regional cruise authority and collective bargaining power constrains CARICOM's ability to negotiate for port investment, tax revenues, and environmental standards aimed at maximizing the benefits of the cruise industry for domestic economies. While the region has relatively competitive, extra-regionally linked transshipment centers, intra-regional shipping connectivity is expensive and often unreliable, making it difficult and costly for local producers to get their goods to market (Wilmsmeier *et al.*, 2006).

So far, the most important transport initiatives at the regional level have been in regulation of air transport, where the Regional Aviation Safety Oversight System (RASOS) sets guidelines for aviation safety and a Multilateral Air Services Agreement (MASA) governs intra-regional air traffic. But while the RASOS faces technical and financial constraints, some components of the MASA run counter to the region's single market goals and need to be revised. Progress towards adopting a common transport policy, as envisioned in the CARICOM Treaty, has been slow (Bertrand, 2006).

Information and communications technology (ICT) is not captured in detail in the CARICOM Treaty, but is also of fundamental importance to integration and economic development in the region. In February 2003, ministers in charge of ICT issued the Georgetown Declaration calling for a coordinated approach to ICT policies in CARICOM. A regional ICT strategy, drafted in 2004, highlights physical and regulatory infrastructure development, as well as content and utilization, as main areas of focus. According to Stern (2006a), there are wide discrepancies and some serious gaps in access to physical infrastructure for ICT in the region. For example, fixed and mobile telephony penetration is strong in only a few countries; Internet access and use remain spotty; submarine fiber-optic cables are abundant in some countries, yet access to them remains elusive; and satellite network coverage is good, but prohibitively expensive. Regulatory frameworks are not harmonized within CARICOM, adding transaction costs for investors targeting the regional market. Many regulatory agencies are new; they

operate in environments that, despite recent liberalization, are still dominated by a single operator, and lack expert resources, particularly in dispute resolution. E-government, e-commerce, e-health and e-learning platforms do not currently exist or require strengthening in many CARICOM countries.

Some observers have moreover noted that there is some fragmentation and duplication of mandates for ICT development. Heads of government have mandated different ministerial committees, working groups and agencies to carry out ICT-related policy-making and oversight at the regional level. This has occurred alongside existing inter-governmental and non-governmental institutions, as well as national efforts in the ICT sector. There is thus a need to establish clearer mandates for each relevant agency, within an overall plan for regional development of the sector (Stern, 2006b).

Foreign policy coordination: the focus on external trade

Foreign policy coordination plays a crucial role in CARICOM's integration process. Except in the area of trade, such coordination is pursued in a rather ad hoc manner, mainly through CARICOM's relevant ministerial council, the Council for Foreign and Community Relations. In recent years, the group's foreign policy agenda has encompassed such issues as the promotion of small states in the international community, defense of the group's territorial integrity in border disputes with Guatemala and Venezuela, regional security (mainly in cooperation with the United States and Britain), the OECD's harmful tax initiative, and political events in Haiti. The most dominant issue on the agenda, however, has been foreign trade. This is evident in both the legal and institutional reforms undertaken by member states to forge a common external trade policy, and their joint initiatives to pursue new trade agreements with third countries. As with the CSME, the goal is to raise productivity at home and expand opportunities for Caribbean businesses in global markets.[13]

Apart from the implementation of a common external tariff, efforts to establish a common trade policy among CARICOM member states have centered on coordination of the group's external trade negotiations. Despite its common market goals, CARICOM's original treaty placed few restrictions on member states' ability to negotiate bilateral agreements with third parties. The revised treaty of 2002 limits the flexibility of individual member states to negotiate bilateral trade agreements with third countries by obliging members who negotiate such accords to seek approval from CARICOM's Ministerial Council for Trade and Economic Development (COTED). On the institutional side, the Caribbean Regional Negotiating Machinery (CRNM), created in 1997 to coordinate the group's external trade negotiations, has contributed significantly towards strengthening the region's capacity in this area. In its almost ten years of operation, the CRNM has generated a significant amount of technical work to help formulate and defend CARICOM positions in external negotiations; it has often represented member states at the negotiating table, and has helped build stronger coordination and consultation mechanisms on trade throughout the

region. The CRNM reports directly to the COTED which, in turn, reports to CARICOM's Prime-ministerial Sub-committee on External Negotiations, headed by Jamaica.[14]

The launching of the Free Trade Areas of the Americas (FTAA) process in 1994 undoubtedly influenced and accelerated the region's efforts to strengthen its existing mechanisms for foreign policy coordination, particularly in the area of trade. FTAA talks constituted the first major reciprocal trade negotiations in which the region was actively engaged. In terms of scope and technical complexity, moreover, they far exceeded the various trade and cooperation agreements that Caribbean countries had previously negotiated with the EU as part of the African, Caribbean and Pacific (ACP) group. With FTAA talks on hold since 2004, Caribbean trade negotiators have gained some breathing space in terms of their negotiating calendars, but the region's trade policy agenda remains complex. Currently, CARICOM negotiating efforts focus on completing an Economic Partnership Agreement (EPA) with the EU. Doha Round negotiations could become active again in 2007, following a breakdown of talks in 2006. Recently concluded trade agreements with the Dominican Republic, Cuba and Costa Rica have in-built agendas requiring further negotiations, for example in services. CARICOM has, moreover, taken steps to upgrade its trading arrangements with Canada, and is exploring the possibilities of negotiating a free trade agreement with the United States. Trade relations with the United States will be at the top of the agenda in the coming year, given that the preferences granted to US imports from Caribbean countries under the US Caribbean Basin Trade Preferences Act are set to expire in 2008 unless a free trade agreement between the parties is put in place. Beyond trade negotiations, implementation of resulting agreements also requires coordination among Caribbean countries to avoid problems of trade deflection and to ensure the smooth operation of the single market.

Despite improvements in the legal and institutional structure for trade policy coordination, the region continues to face important challenges in this area. Existing loopholes in the CET and the unfinished agenda of the CSME make it difficult for the countries to present a common front in external negotiations. And while treaty requirements for countries to negotiate collectively have been tightened, the revised treaty does not expressly prohibit CARICOM members from initiating their own negotiations with third countries, and is thus still at odds with the principle of a customs union and, by extension, a single market.[15] Finally, the CRNM's work is constrained by insufficient and unreliable funding, and national trade ministries, on whom the CRNM relies for its work, often lack the technical and financial resources to engage effectively in the negotiating process.

Functional cooperation

In the Caribbean, functional cooperation usually refers to cooperation in areas not directly linked to economic integration, including disaster risk management, education, environment, health and security. In contrast to foreign policy

coordination, which is directed towards an external party, functional cooperation focuses inward, although there is often overlap in the issues covered by both pillars of integration. Security, for example, involves both intra-regional cooperation initiatives and close collaboration with external partners. The distinction between functional cooperation and economic integration is also blurred, since it is often difficult to determine what is strictly "economic" or "non-economic", and because cooperation in areas that are closely linked to economic development, such as agriculture or transport, often resembles a looser form of functional cooperation, rather than what is traditionally understood as real economic integration.

Perhaps more than economic integration, functional cooperation produced some clear, early results in the Caribbean integration process. Regional institutions such as the University of the West Indies, the Caribbean Examinations Council, the Caribbean Meteorological Organization and the Caribbean Development Bank all predate or coincide with the establishment of CARICOM more than thirty years ago, and continue to provide important services to Caribbean countries today. Part of what has driven these initiatives is that, in contrast to economic integration, functional cooperation is perceived as less of a threat to national sovereignty, and often yields more immediate, measurable benefits. It usually evokes less political resistance and is therefore easier to implement.

While such cooperation covers a variety of areas, most efforts in the past decade have focused on education, health and disaster risk management, with important achievements in each area. More recently, security issues have gained increasing importance on the regional agenda, and cooperation has been particularly active in preparation for the 2007 Cricket World Cup, the largest sports event ever hosted by the region. Notwithstanding these achievements, functional cooperation has fallen far short of what could be expected from countries that, early on in their integration efforts, recognized the constraints that small size imposes on their fiscal space and the benefit they could obtain from pooling their resources to achieve better provision of social services in the region.

A common problem across many areas of functional cooperation is that of unclear or overlapping institutional mandates and limited resources to implement regionally agreed policies and action plans. Many actors are involved in functional cooperation. CARICOM's Council for Human and Social Development plays a key role, as do the CARICOM Secretariat and numerous specialized regional agencies. Many of these agencies receive most of their funding from external donors, raising questions about sustainability and ownership of their agenda. The agencies are often trapped in a pattern whereby lack of sufficient funding prevents them from fulfilling their mandates; this, in turn, can affect their performance and reduce the incentive for governments and donors to provide further funding. Greater regional engagement in these agencies is crucial in order to create long-lasting benefits from functional cooperation. Setting clear priorities for functional cooperation is also vital, since cooperation initiatives require both start-up funding and continued government support thereafter.[16]

CARICOM's institutions

In the late 1990s, member states instituted some changes to CARICOM's governing structure and institutions. The revisions aimed to improve the decision-making process and strengthen the group's capacity to implement and enforce regional agreements. As a result of these changes, several new agencies and bodies were added to the Community's institutional structure, and some are now operational.

While decision-making is still constrained by CARICOM's largely intergovernmental structure, there has been some progress in this area in recent years. Ministerial councils meet on a more regular basis than before, and can, at least in theory, take decisions by qualified majority vote, although in practice the spirit of unanimous consent prevails. There is better coordination between regional and national agencies involved in integration issues and, at the national level, better inter-agency coordination. In 2002, moreover, CARICOM governments established a "quasi-cabinet" of individual heads of state to spearhead action in critical areas of integration. Two portfolios have been particularly active in driving the process: the CSME portfolio, led by the Prime Minister of Barbados, and the external negotiations portfolio, led by the Jamaican Prime Minister. These developments have facilitated a more dynamic integration agenda in recent years.

Implementation of Community decisions has been supported by the creation, in 2002, of a special CSME Unit in the CARICOM Secretariat to help define and implement the CSME work program, the creation of "focal points" in each CARICOM member state to oversee CSME implementation, and the establishment of the Caribbean Court of Justice (CCJ), which, however, has yet to hear its first case. As to specific areas of Community policy, the CARICOM Regional Organization for Standards and Quality (CROSQ), which began operations in 2003, should help increase the pace of standards development and harmonization in the region. With the possible exception of the CCJ, however, these institutions suffer from significant resource constraints. The CSME Unit is significantly understaffed in relation to its comprehensive mandate. Broader institutional weaknesses in the CARICOM Secretariat also affect implementation, since various units beyond the CSME Unit are involved, and because the Secretariat oversees many donor-financed programs in support of the CSME. Except in Barbados and Trinidad and Tobago, national focal points lack the political and institutional clout needed to effectively coordinate the implementation process, and CROSQ is understaffed and overly dependent on donor funding.

Still pending is the planned creation of a Regional Competition Commission and adoption of a Community Competition Policy. Only three member states currently have competition laws in place, and only two have institutional arrangements to enforce them. Limited knowledge of competition law and policy among businesses, a dearth of technical expertise, and, more generally, the absence of a culture of competition in CARICOM make progress in this area

very difficult. Progress is nevertheless vital since, in its absence, the benefits expected from the CSME could be frustrated by anti-competitive business conduct. Also pending is the creation of a regional administration body for intellectual property (IP) rights. IP protection is fundamental to the promotion of innovation – which can boost productivity and competitiveness – and crucial for attracting foreign investment. Stronger regional cooperation in this area could save costs and yield important benefits to member states (Brewster *et al.*, 2003).

Monitoring and enforcement of Community decisions is still a problem, despite efforts to improve this aspect of integration through more regular meetings of the ministerial councils, more active follow-up on pending implementation issues by the Secretariat, and the establishment of the CCJ. First, the CCJ can only act in matters of dispute; it is not responsible for monitoring and enforcing the implementation of Community decisions on a day-to-day basis. Second, the ministerial councils, which do have a clear monitoring role, have a much weaker mandate when it comes to enforcement. Third, the councils rely heavily on the CARICOM Secretariat and national focal points to provide them with the necessary information for monitoring. The Secretariat's monitoring efforts, however, are not yet well developed, and countries themselves often lack an overview of what specific legal and administrative actions they have to take to implement CSME-related decisions. This makes enforcement even more difficult. To facilitate implementation, relevant Community organs must be given stronger enforcement mandates, better monitoring systems must be designed, and sufficient resources allocated to make them operational.

The CARICOM Treaty calls for an efficient system of consultations on integration at the national and regional levels. At the government level, all member states have identified a ministry with responsibility for CARICOM Affairs, and all CSME members have designated an official CSME Unit or focal point. In addition, most countries have set up an Inter-ministerial Consultative Committee, and several have created formal structures for consultation with the private sector and other civil society actors. The CARICOM Secretariat and some member states have moreover launched campaigns to raise public awareness of the integration process and its projected benefits. The above initiatives are important improvements over the situation prevailing a decade ago, when few consultations took place between those directly involved in regional policy-making and the rest of the Community. Now that consultative mechanisms have been established throughout most of CARICOM, the challenge is to make them work. Despite the new structures, information exchange and communication among ministries remains a problem in several countries. In addition, private sector participation in the formal integration process remains weak except in a few countries, and the public in general is ill informed about regional integration. Further outreach and awareness building is needed to encourage policy debate and strengthen the democratic foundation of integration.[17]

Looking ahead: main issues on the regional policy agenda

Despite repeated setbacks and delays in the process, Caribbean countries have made significant progress towards deeper integration, particularly in the past decade. While the CSME is far from being a reality and the customs union remains incomplete, CARICOM is more advanced than other integration groups in the hemisphere in terms of liberalization of services trade and the movement of capital and people among its member states. It has begun the process of policy harmonization in a number of areas related to economic policy, has strengthened its foreign policy coordination, negotiates as a bloc in external trade fora, and has established a number of successful functional cooperation initiatives over the years. The prevailing economic context in which Caribbean countries are seeking to build a single market and economy is not an easy one. In the last decade, most countries in the region have witnessed sluggish growth, weak export performance, growing fiscal constraints, high unemployment and rising crime levels, along with eroding trade preferences and ever-harsher competition in world markets. Caribbean countries are among the most indebted in the world, and for many of them debt levels have increased in recent years. That regional integration has not faded from government agendas in this challenging context attests to the strong political support it enjoys among government leaders in the region.

Yet despite such support, regional integration has been beset with delays. This is due to a variety of factors, including the complexity of the process, the scarcity of resources to support it, high levels of economic disparity and divergence among member states, perceptions and fears of unequal distribution of the benefits and costs of integration, limited popular support for and knowledge of the process, and, above all, a strong desire among governments to preserve national sovereignty. The latter, in particular, has created (and sustained) institutional inefficiencies and a regional governance structure that is not conducive to deeper levels of integration. Because deeper integration is necessary to generate the benefits of integration, addressing these constraints is an urgent task.

It is perhaps helpful, at this stage, to recall the main objectives of integration as outlined in CARICOM's treaty: accelerated and sustained economic development through increased productivity, higher levels of international competitiveness, and more efficient operation of health, education and other social services. If the integration process can demonstrate clear benefits in terms of economic growth, and if effective mechanisms to address the distributional effects of integration can be put in place, then governments might be more willing to assume the perceived costs of loss of national sovereignty in the process of deepening their integration arrangement. Making CARICOM a more effective instrument of economic growth for its member countries, and dealing effectively with the distributional aspects of integration, should therefore be two key objectives guiding the group's regional integration agenda in the coming years.

Facilitating growth through integration

The issue of economic size is important in this respect. As Mesquita Moreira and Mendoza (2006) argue, size constraints matter not only as an incentive for regional integration, but also because they determine the specific gains Caribbean countries can derive from their regional integration process. The regional market, even when fully integrated, will still be small in economic size. The traditional trade-related gains from economic integration, in terms of allocative and scale effects, will therefore be modest, even in a fully functioning CSME where intra-regional trade liberalization is accompanied by full factor mobility and harmonized economic policies. This is particularly true in a region characterized by high trade openness (because access to world markets mitigates size constraints in the tradable goods sector) and similar factor endowments across countries (which limit the scope for intra-regional trade). Because the gains are modest, they can easily be rendered irrelevant by remaining imperfections in the free trade area or customs union, or obstacles to the free flow of services, capital and labor within the region, which can constrain the effective allocation of resources across the CSME and intensify adjustment costs from intra-regional liberalization. For CARICOM, therefore, full intra-regional market liberalization and integration is more crucial than for larger integration groups, which can perhaps more easily afford exceptions to customs union or common market discipline. To enhance the benefits of their single market, CARICOM countries should therefore strive to eliminate remaining restrictions to the free flow of goods, services, capital and people within the CSME, and fix the loopholes in the common external tariff, attempting at the same time to reduce the high level of tariff dispersion in the CET. Implementation of full labor mobility in the CSME would have to be a gradual process in order to avoid major economic disruptions and a consequent political backlash to integration in both origin and destination countries. It should not, however, indefinitely exclude unskilled labor from enjoying the rights of (legal) mobility.

While size constraints limit the traditional trade-related gains that Caribbean countries can derive from economic integration, the gains from regional cooperation in *non*-trade areas could be significant precisely because the countries are so small. This is because the advantages of size (or disadvantages of small size) go well beyond the production of tradable goods and services. In contrast to Caribbean countries, larger countries have lower per-capita costs in the provision of public or quasi-public goods such as infrastructure, regulatory systems or security; can provide better insurance to region-specific shocks such as natural disasters; can better internalize cross-regional externalities by centralizing the regulation of externality-prone activities, for example through environmental regulation; and can attenuate regional disparities with redistributive schemes. In the production of these “goods”, which play a critical role in the region’s productivity, competitiveness and growth prospects, trade openness can do very little to mitigate the constraints of small size. These are by definition non-tradable “goods” and therefore countries cannot resort to trade to find an altern-

ative and cost-effective source of supply. Without pooling their resources, small countries either carry a heavy fiscal burden to produce and have access to those "goods", or have no access to them at all. While the single economy provisions of the CSME aim to expand regional cooperation in the production of non-tradables, many details of such cooperation are still to be defined.[18]

Greater commitment, clearer priorities, more effective resource pooling and more funding are all needed to revitalize the Community's sectoral work. Most importantly, perhaps, there is a need to build awareness in the region about the significant gains that can be derived from greater regional cooperation and common approaches in these areas – this would help raise support for such initiatives at the national level. The objective, in all sectors, should be to facilitate market-led, internationally competitive production of goods and services through cooperation in the provision of technical assistance, training, business development and other services, and to coordinate national policies in order to avoid negative regional externalities of such policies, rather than to promote production-sharing or other traditional industrial policies that have proven to be both costly to implement and economically inefficient.

From a competitiveness point of view, two areas of regional cooperation require particularly urgent attention: transport and ICT. A common transport policy and more sustained efforts to address current bottlenecks in both the air and maritime transport sectors would facilitate intra-regional trade and enhance the region's overall competitiveness. In the area of ICT, policy and regulatory harmonization, greater resource sharing among regulatory agencies and, eventually, the creation of common regulatory structures could help strengthen ICT connectivity in the region, as could common efforts to build e-government and e-learning initiatives. There is also room for much closer cooperation in many traditional areas of functional cooperation. Skills development, for example, is crucial to building and sustaining the region's competitiveness; so is greater and more effortless mobility of skills across the region. Regional initiatives for international testing and benchmarking of education systems, strengthening of national and regional accreditation bodies, and an expansion in the supply of regional training programs are just some examples of how cooperation could be strengthened in this area.

Aligning CARICOM's regional and global integration agendas

Along with the degree of intra-regional liberalization and cooperation in non-trade areas, levels of external protection also determine to what extent the CSME can help boost the productivity and international competitiveness of local firms and industries. Interestingly, many of the fastest growing intra-regional exports in recent years have not been overly protected from extra-regional competition, since the CET for these products is at or below 5 percent. Such exports have mainly originated in Trinidad and Tobago, and consist of mineral fuels, lubricants, chemicals and related materials. But they also include a number of products from other CARICOM countries. In contrast, intra-regional

trade in products that are highly protected from external competition, with preference margins of 10 percent or higher, has grown much more slowly. Hence, rather than fostering the development of local industries and more dynamic intra-regional trade, external protection appears mostly to have sustained inefficient domestic production – a fact substantiated by analysis of the product composition of intra-regional trade which, as noted earlier, shows little diversification and product innovation over time.[19]

Most of the highly protected products are in the food and manufacturing sectors. While many of them are consumer products, some are intermediate goods that are used in local production processes. Even consumer goods are used in the development of local industries, and their price can thus affect the region's international competitiveness; one prominent example is the cost of food for the tourism industry. From an efficiency point of view, it would therefore seem that a further reduction in CET levels would benefit CARICOM, since it would help shift local production away from inefficient to more productive activities. Moving in that direction nevertheless presents a huge challenge for governments, given the range of local production activities and the amount of intra-regional trade that would be affected. Currently, products with high protection levels account for around 30 percent of all intra-regional exports, or 36 percent in value terms. The latter figure is much higher, at over 70 percent, if Trinidad and Tobago is excluded from these calculations. Thus, a sizeable portion of intra-regional goods trade, and particularly of exports not originating in Trinidad and Tobago, would be vulnerable to further external trade liberalization. To this must be added all those local production activities that do not generate intra-regional trade but are equally vulnerable to external competition. Governments must balance the efficiency gains (and consumer benefits) of further reductions in the CET against the costs of losing local production in sectors that may not be internationally competitive, but are deemed important in light of their contributions to local food security and employment. Loss of fiscal revenue is another concern, particularly for the OECS countries.

Currently, there does not seem to be much political support in CARICOM for further unilateral reductions in external protection levels. Nonetheless, effective protection could decline as a result of further multilateral trade liberalization under the WTO, or bilateral trade agreements such as the Economic Partnership Agreement that CARICOM and the Dominican Republic are currently negotiating with the EU. How CARICOM countries engage in external trade negotiations, what agreements they ultimately achieve, and how they implement them will significantly influence their economic growth prospects and the benefits they can obtain from their regional integration process.

Four issues are particularly important in this respect. First, the effective timing and sequencing of future bilateral negotiations will be important. This is not only because results in one negotiation can influence what CARICOM can obtain in others, but also because the region has limited capacity to engage in several large negotiations at the same time. A related challenge is to ensure that external negotiations are aligned with developments in the CSME, and that the

two processes are mutually supportive. The CSME should provide the basis for a common CARICOM approach to external trade negotiations, but cannot do so in the absence of common regimes in areas such as air and maritime transport services, financial services, competition policy, government procurement, investment or intellectual property rights – all of which are covered in external negotiations. Solving these issues internally prior to completion of external negotiations would facilitate the formulation of a common negotiating strategy and increase the region's bargaining power. Failing to do so could weaken the region's influence and, perhaps more importantly, breach the integrity of the regional integration process because its future development would be shaped (and possibly compromised) by external commitments (Bernal, 2005).

Second, greater efforts to strengthen both the CRNM and national trade agencies would help Caribbean countries confront the complex negotiating agenda they will face in the coming years. Third, CARICOM countries would benefit from pursuing a more offensive, rather than defensive, trade policy agenda. Trade preferences long enjoyed by Caribbean countries in their major export markets are eroding. In response, CARICOM has made efforts to preserve what it can in EPA and WTO negotiations, and to seek compensation for losses owing to changes in relative market access – for example, in response to modifications in the EU banana and sugar import regimes, which have seriously affected prospects for these industries in the Caribbean. In the coming years, it will become increasingly important for CARICOM to also focus on the offensive side of negotiations – not only to defend current market access conditions, but also to push for better access in new areas such as services, where Caribbean countries have real opportunities to expand their global presence, but where, as in merchandise trade, they are struggling to maintain their share of the global market (see Figure 9.4). Exploring new markets in Asia and Latin America will also be important. To negotiate effective opening of their own markets, CARICOM countries will need to determine the fiscal impact of alternative tariff reduction schedules, as well as the impact of liberalization on the region's various industries. In all these efforts, access to detailed, up-to-date and reliable trade and production statistics is crucial. The region's weak capacity to generate these and other economic data constitutes a major challenge for CARICOM, and requires more concerted efforts at regional cooperation in statistics collection and management.

Finally, timely implementation of negotiated trade agreements, and efficient adjustment to the economic changes resulting from them, will be crucial. As with the negotiating effort, some implementation issues could be handled more efficiently – and at lower cost – at the regional rather than the national level. The biggest challenge will be to help the Caribbean private sector adjust effectively to a more liberalized trading environment. The benefits deriving from trade liberalization will be neither achievable nor sustainable without improvements in the region's trade-related infrastructure and production capacities. Governments will have to play an active role in the transition process by supporting improvements in infrastructure and fostering a more business-friendly environment that

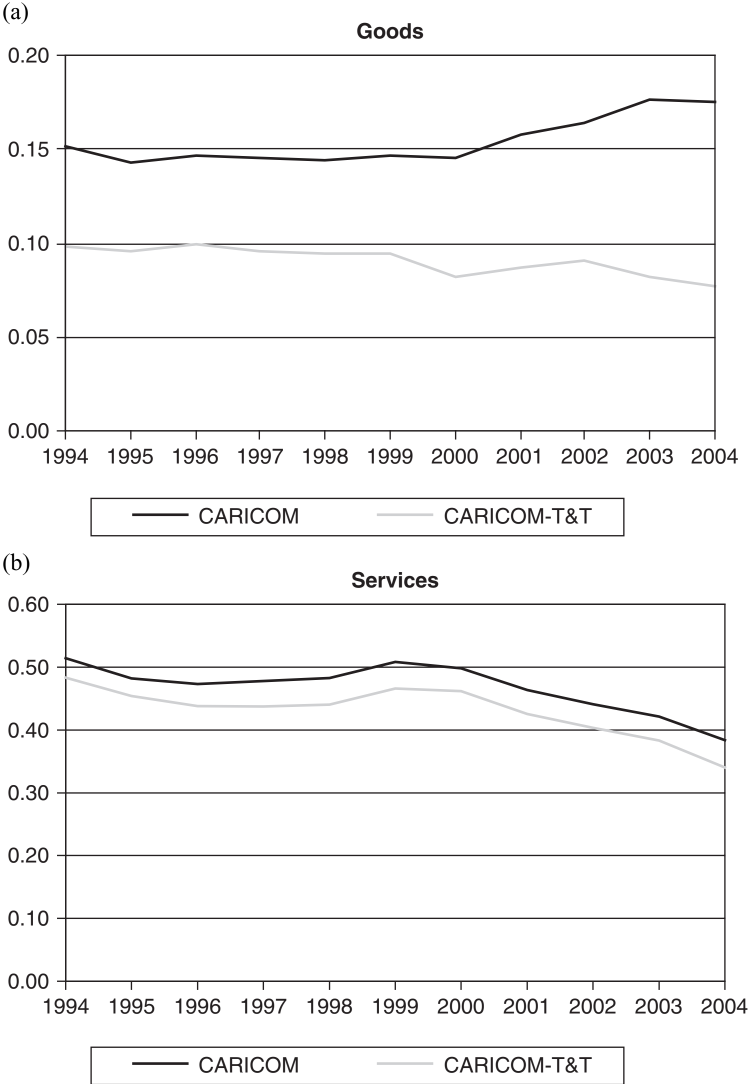

Figure 9.4 CARICOM share in world exports of (a) goods and (b) services (source: IDB Integration and Regional Programs Department, based on WTO data).

encourages and rewards innovation, initiative and risk-taking, while offering transparent laws and regulations and a stable macroeconomic environment. They will also need to develop social safety nets and other such services in order to soften the impact of adjustment. In all these areas, there is ample room for regional cooperation.

Managing the distributional risks of integration

One of the main problems holding up the integration process has been a widespread perception, in many countries, of unequal distribution of the benefits and costs of integration. This is a particularly serious problem given the already high level of existing economic disparities between Caribbean countries (Figure 9.5). The smaller and less developed countries in the region (LDCs) fear that further intra-regional liberalization will harm their domestic industries while benefiting those of countries that have already attained a higher level of development. Economic theory lends some support to this concern. Because of similar factor endowments among countries, South–South agreements such as the CSME are particularly prone to trade diversion and agglomeration of economic activities in larger countries, at the expense of the smaller ones. To avoid a politically unsustainable scenario where large and wealthier countries reap the greatest benefits from integration, it is important to "tilt the playing field" in favor of the smaller and less developed partners (Mesquita Moreira and Mendoza 2006).

CARICOM governments have sought to devise specific mechanisms to assist the weaker members of the Community. These mechanisms fall into three broad categories: (i) protective measures intended to hinder or slow the liberalization process, including temporary derogation from obligations to grant the right of establishment or national treatment to service providers, suspension of imports to protect local import-competing industries, and longer timeframes for implementing CSME commitments; (ii) allowing countries to adopt special measures to help local industries become more efficient (subsidies) or to attract investment (incentives); and (iii) technical and financial assistance through the creation of a Regional Development Fund that aims to help disadvantaged countries, regions and sectors cope with CSME-related adjustment. In recent months, member states have made progress in defining the scope, functions and management of the fund, but it is not yet operational.

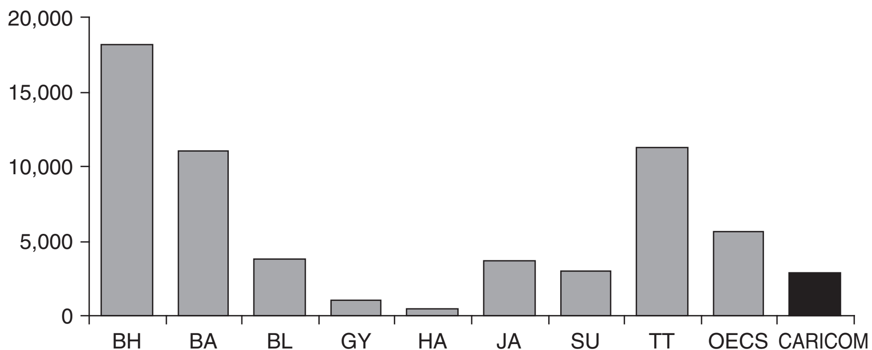

Figure 9.5 Per capita income for CARICOM countries, 2005 (current US$) (source: IDB Integration and Regional Programs Department, based on World Bank; IMF; World Economic Outlook Database).

All three mechanisms pose challenges, and, with the possible exception of the Regional Development Fund, have done little so far to assuage the concerns among LDCs regarding deeper integration. The first, protection, is the least gainful in economic terms. It contradicts the very principle of a single market and, while providing temporary relief to the benefiting country or industries, may generate economic costs to the group as a whole that far outweigh the benefits of special treatment, mainly because of the imperfections it creates in the free trade area and customs union. As noted earlier, removing such imperfections is necessary to reap even modest trade-related gains from economic integration. The second mechanism does not impede free trade and factor mobility, but is difficult to implement for LDCs given that they lack fiscal space to introduce comprehensive subsidy or incentive regimes. In fact, a common problem in existing integration arrangements has been that larger, wealthier members of a group can more easily afford to provide credit incentives to companies investing in their territories, exacerbating the scale advantages that often produce agglomeration of economic activities in those countries, particularly in South–South integration arrangements. Convergence of fiscal and other credit policies can help avoid this trend, and can even, within a context of greater overall harmonization, give smaller, less developed countries the possibility of offering more generous incentives than their larger counterparts. A common approach to funding such a mechanism at the regional level, for example through a distribution criterion of the common tariff revenue that would favor LDCs, would make it possible to implement the mechanism despite the fiscal constraints faced by LDCs (Mesquita Moreira and Mendoza, 2006).

The regional development fund is the least distortive and theoretically the best way of harnessing support for the CSME among LDCs. If implemented and managed effectively, it could go some way towards helping to redress the problem of growing asymmetries in the CSME, but weak capitalization of the fund so far has revealed some reluctance on the part of the more developed countries to foot the bill of adjustment in the weaker economies. If the fund were to yield quick results, it would not only persuade member states and donors to keep it capitalized, but also encourage LDCs to proceed with intra-regional liberalization.

A separate yet related challenge that will confront CARICOM member states in the coming years is how to bring Haiti into the CSME. Although it has been a member of CARICOM since 2002, Haiti does not yet participate actively in the Community's various foreign policy coordination and functional cooperation initiatives, and it is unclear when and how it will join the CSME. Because Haiti is so much larger in population and so much poorer in economic terms than any of the other CARICOM members, its full integration into the regional market could have significant effects for the other members. The challenges of Haiti's membership go much further than its impact on intra-regional merchandise trade or its implications for labor mobility within the region, given that its high poverty levels would make it a significant competitor for technical assistance and adjustment funds under the RDF. Haiti's full entry into the CSME would

thus require careful planning and a gradual approach in order not to disrupt intra-regional flows and exacerbate existing problems of asymmetry in CARICOM.[20]

Facilitating deeper integration: the challenge of institutional reform

One could argue that some of the most important problems that CARICOM faces in moving towards deeper integration could in fact be solved by deeper integration itself. Deeper integration in both trade and non-trade areas would help boost the growth prospects of Caribbean economies, by creating greater efficiencies in the regional market through intra-regional liberalization and more cost-effective provision of common services. This, along with more effective regional mechanisms for managing the distributional risks of integration, would generate greater support for integration among the LDCs and thus sustain further efforts at integration.

There are, however, some doubts about CARICOM's ability to move rapidly towards deeper integration, and particularly towards a single economy, under its current governing structure. As noted earlier, decision-making in the Community is still hampered by CARICOM's largely inter-governmental structure, CARICOM's ministerial councils have little power to enforce Community decisions, and regional institutions lack sufficient resources to implement their mandates efficiently.

CARICOM governments are well aware of these constraints and, in July 2003, issued the *Rose Hall Declaration on Regional Governance and Integrated Development*, which calls for a number of changes in the Community's governing structure to facilitate deeper integration. The declaration proposes, among other things, the creation of a CARICOM Commission with executive responsibilities for core areas of regional integration, as well as the creation of mechanisms for the automatic transfer of funds to Community institutions to address the lack of stable and sufficient financing that has constrained their capacity to function effectively. Yet despite the creation of an Expert Group on Governance and a series of reports and recommendations issued by that group, decisions on governance and financing are still pending three years after the Rose Hall Declaration. As in other integration groups, national sovereignty remains a fiercely guarded asset among the Caribbean countries, and it will probably take some time for member states to institute a governance structure that is more conducive to deeper integration. Meanwhile, however, implementation of some of the above recommendations could help demonstrate the benefits of pooling national sovereignty at the regional level by delivering concrete results in terms of growth or the generation of efficient public goods.

Notes

1 Operations Specialist, Inter-American Development Bank (IDB), Integration and Regional Programs Department. The ideas and opinions expressed in this paper are

those of the author and do not necessarily reflect the policies and positions of the IDB. Thanks to Mauricio Mesquita Moreira, Matthew Shearer, Mariana Sobral de Elia and Christopher Vignoles for their valuable contributions to this paper.

2 The paper updates and summarizes the main findings of previous work by the author, and draws mainly on: Institute for the Integration of Latin America and the Caribbean (INTAL), *CARICOM Report No. 2*, Anneke Jessen and Christopher Vignoles, Subregional Integration Report Series. Buenos Aires: IDB-INTAL, 2005; Inter-American Development Bank (IDB), *IDB Regional Strategy for Support to the Caribbean Community (2007–2010)*, Washington, DC: IDB, 2006; and Anneke Jessen and Ennio Rodriguez, *The Caribbean Community: Facing the Challenges of Regional and Global Integration*, INTAL-ITD Occasional Paper 2. Buenos Aires: IDB-INTAL, 1999.

3 OECS countries are Antigua and Barbuda, Dominica, Grenada, St Kitts and Nevis, St Lucia, St Vincent and the Grenadines and the dependent territory of Montserrat.

4 Some of the provisions of the Revised Treaty had already entered into force on a provisional basis in the late 1990s, following the completion of a series of new protocols relating to the single market.

5 Haiti's average applied tariff is 2.9 percent, while that of The Bahamas is 30.4 percent. See World Trade Organization, *Trade Policy Review: Haiti*, Geneva: WTO, 2003 and UNCTAD-TRAINS Database, respectively.

6 Of the 474 restrictions notified by member states under Chapter III, 133 are deemed necessary regulations or are associated with monopolies and are therefore not subject to removal.

7 A common problem that affects establishment is restricted access to property. According to Brewster *et al.* (2003), countries have in the past made extensive use of limitations to landholding by applying Article 149 of the treaty.

8 The right of establishment, for example, is hindered by the absence of a regional system of company registration to facilitate harmonization of regulation and oversight. Moreover, as part of the treaty's in-built agenda, member states have yet to develop a protocol on rights contingent on establishment, provision of services and movement of capital in the Community.

9 For many Caribbean countries, the real importance of intra-group merchandise trade is much smaller than Figure 1.2 would suggest. In Barbados, for example, merchandise exports represent only about 20 percent of the country's total exports, the rest are services. So, even if almost half of Barbados's goods exports go to CARICOM, this represents less than 10 percent of the country's total exports. The situation is similar for Jamaica, The Bahamas and the Eastern Caribbean countries, which are also mainly services exporters.

10 For a more detailed analysis of trends in intra-regional trade, see INTAL (2005), 21–26.

11 Direct investment corresponds to Mode 3 services trade as defined in the General Agreement on Trade in Services (GATS). For a discussion of intra-regional investment flows, see Farrell (2003).

12 The OECS, The Bahamas, Barbados and Belize have a fixed exchange rate regime; the others have floating regimes (or managed floats).

13 For a fuller discussion of CARICOM's foreign policy coordination, including its legal framework, see INTAL (2005).

14 For an analysis of the CRNM's role in the region's external trade negotiations, see Jessen (2004).

15 The treaty did not prevent Trinidad and Tobago from initiating trade negotiations with Costa Rica, which were only later expanded to include all CARICOM members. Guyana, moreover, has a bilateral treaty with Brazil, and Belize benefits from a special provision in the treaty by which it retains the right to enter into bilateral agreements with neighboring countries in Central America. While it appears that member

states are adhering to their obligations under the revised treaty, the treaty itself thus exhibits some shortcomings in terms of the Community's stated single market goal.

16 For a more detailed overview and assessment of the region's functional cooperation efforts, see INTAL (2005) and Thomas (2006).

17 For a more detailed overview and assessment of the region's institutional architecture, see INTAL (2005). CARICOM's official website, www.caricom.org, also contains detailed information on institutional aspects of its integration process.

18 For a broader discussion of the costs and benefits of integration for CARICOM, particularly as they refer to traditional trade-related gains of economic integration versus cooperation in non-trade areas, see Mesquita Moreira and Mendoza (2006).

19 For a more detailed analysis of protection levels in intra-regional trade, see INTAL (2005).

20 For a broader discussion of Haiti's membership of CARICOM, and the potential benefits and challenges this represents for both Haiti and the remaining member states, see Suominen (2006).

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10 Trends in Latin American integration

An overview[1]

Osvaldo Rosales, José E. Durán Lima and Sebastián Sáez

Introduction

Regional integration is at a crossroads. The Doha Round is experiencing serious difficulties, and more and more bilateral trade agreements are being negotiated at the same time with partners both inside and outside the region, making it necessary to reinforce consistency among trade policies at different levels: multilateral, hemispheric, subregional, bilateral and unilateral. The multiplicity of levels at which negotiations are taking place and the large number of decisions that must be adopted at those different levels require a clear internal consensus regarding not only the priorities for establishing an international presence, but also the consistency that must be maintained among the various public policies that come into play in the international sphere.

In this multifaceted situation, there is no sign that integration mechanisms have corrected the shortcomings of the past: weak dispute settlement mechanisms; adoption of trade regulations that are not incorporated into national legislation or are not implemented; lack of effective institutional arrangements; absence of macroeconomic coordination and inadequate or non-existent efforts to deal with the asymmetries of the integration scheme. These challenges exist, albeit with different shades and variations, in the Southern Common Market (MERCOSUR), the Andean Community and the Central American Common Market (CACM), although greater institutional progress has been made in the latter two.

MERCOSUR–European Union talks could not be completed in 2004 as planned, and apparently the political momentum will not be regained until after the Doha Round. MERCOSUR has expressed interest in launching free trade talks in 2005 with CARICOM, Mexico and Morocco, respectively, as well as partial trade agreements with India and with the Southern African Customs Union (SACU). In addition, free trade negotiations between the Andean Community and MERCOSUR have concluded, and the agreement is already in effect. In early July 2005 the MERCOSUR countries became associate members

of the Andean Community, and Chile should gain that status soon. Talks are also taking place between the Andean Community and El Salvador, Guatemala and Honduras. In 2004, three Andean Community Member States (Colombia, Ecuador and Peru) started negotiations on a free trade agreement with the United States. Peru concluded these negotiations in December 2005, and also signed a trade agreement with Thailand. Colombia concluded the negotiations with United States in February 2006. It is clear, then, that there is a broad agenda for international negotiations that also calls for the region to participate actively in the multilateral scenario of the Doha Round. Such a demanding agenda can sometimes distract attention from the efforts necessary to update and streamline the subregion's own integration schemes.

The agreements between the United States and Central America and the Dominican Republic, on the one hand, and between it and Andean Community–3, on the other hand, pose an additional challenge to the respective integration schemes. Indeed, on several important issues, commitments of greater scope and impact than those included in the integration schemes are under consideration for these accords. This is a major opportunity and challenge for these schemes. In general, trade agreements with industrialized economies tend to be viewed as more binding by regional economic players, and their dispute resolution mechanisms are seen as more credible and thus providing greater legal security for decisions on investment and foreign trade. Moreover, in the agreements with the United States or the European Union, the commitments countries can make in some aspects of investment or services policy are undertaken within the framework of most-favoured-nation (MFN) status, and they therefore pull the integration schemes into decisions in which they did not participate. This "pulling" opens up the possibility for a rapid adjustment of integration regulations to avoid the risk of being overtaken by events.

In a number of areas, this can become quite complex, and a great deal of pragmatism is required to adjust to the new reality, making the appropriate changes in integration regulations and institutions. In this connection, it is important to preserve the central idea of an expanded market with free movement of goods and factors, serious progress towards macroeconomic coordination, effectively binding dispute resolution mechanisms, adequate handling of asymmetries, management of structural funds so as to yield balanced benefits, and bold initiatives in energy and infrastructure. It is a matter of persuading the economic and political players to see it this way, and that will not happen without a decisive political impetus, which in turn requires taking risks and fighting domestic interests that advocate protectionism. To be sure, it is even more imperative that this type of internal consensus be built – and leadership is even more critical – in the larger economies of the region. If this does not happen, it will be quite difficult for subregional integration to adapt quickly to current and future challenges.

The first section of this paper examines the recent trends of the integration process in Latin American and Caribbean countries (LAC), and analyses the evolution of intra-regional trade. The second section addresses the main issues that are currently part of the integration process debate in LAC. The third

section discusses more specifically the main debates and challenges in LAC regional integration schemes, and the final section presents the conclusions.

Integration process and intra-regional trade

Intra-regional trade still very low

Intra-regional trade is still low compared to what is being seen in Asia and the European Union, for example. While in LAC this figure amounts to 18 per cent of exports, in Asia it is just over a third, and it is nearly two-thirds in the European Union. There is a slowly rising trend in Asia, but in Latin America this trade is lower than it was a decade ago, which shows that intra-regional trade has not managed to become an engine of growth. The CARICOM and CACM figures are much higher than the averages recorded in MERCOSUR and the Andean Community. The latter is the furthest behind in terms of the weight of its intra-regional trade, as only 10 per cent of its exports go to the Community market; Peru and the Bolivarian Republic of Venezuela report even lower amounts (see Tables 10.1–10.3).

According to the figures for 2005, the greatest amount of intra-group trade is in CACM and the least in the Andean Community. Trade with the United States is more significant than intra-group trade in every case, and the same is true with respect to the European Union in every case except CACM. Intra-group trade in MERCOSUR and CARICOM is less than their trade with the United States, the European Union and Asia, respectively (see Table 10.2).

One prominent feature of this trade is the greater propensity to export manufactured goods within the subregions (see Table 10.3). This is particularly important in view of the fact that regional integration offers an attractive possibility to expand markets, scales of production, and the growth of higher quality, higher value-added exports, especially of knowledge-intensive goods (Kuwayama and Durán Lima, 2003). These markets can also provide an excellent opportunity to learn and gain experience in trade, as well as a launching pad to reach extra-regional markets. Such export diversification, which makes it possible to export goods with a higher value added to the subregions, is especially important for the Andean Community and CARICOM. Given the low coefficients of intra-regional trade, however, it is evident that this potential is far from being realized.

Intensity of intra-regional trade in South America

An examination of intra-regional trade matrices reveals that CACM has consistently more intensive intra-bloc trade than any other subregional integration scheme, and that El Salvador is more committed than any other country to this trade, with 54 per cent of its exports oriented towards the subregion. Bolivia and Paraguay play the same role in the Andean Community and MERCOSUR, respectively. At first, it seems reasonable to expect relatively smaller economies to be the most oriented towards intra-bloc trade within each

Table 10.1 Latin America and the Caribbean: total exports and exports by subregional integration scheme, 1990–2005 (millions of current dollars and percentages)

	1990	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
Andean Community																
Total exports (1)	31,751	28,583	28,100	29,683	33,706	39,134	44,375	46,609	38,896	44,603	60,709	53,543	52,177	54,716	74,140	94,751
Percentage of annual growth	25.7	–10	–1.7	5.6	13.6	16.1	13.4	5	–16.5	14.7	36.1	–11.8	–2.6	4.9	35.5	27.8
Exports to the Andean Community (2)	1,312	1,769	2,118	2,892	3,752	4,812	4,762	5,628	5,504	3,940	5,167	5,656	5,227	4,900	7,361	9,056
Percentage of annual growth	26.3	34.8	19.8	36.5	29.7	28.2	–1	18.2	–2.2	–28.4	31.1	9.5	–7.6	–6.3	50.2	23.0
Percentage of intra-Community exports (2:1)	4.1	6.2	7.5	9.7	11.1	12.3	10.7	12.1	14.2	8.8	8.5	10.6	10.0	9.0	10.5	9.6
MERCOSUR																
Total exports (1)	46,403	45,869	50,487	54,328	61,890	70,129	74,407	82,596	80,227	76,305	85,692	89,078	89,500	106,674	134,196	162,512
Percentage of annual growth	–0.3	–1.2	10.1	7.6	13.9	13.3	6.1	11	–2.9	–4.9	12.3	4	0.5	19.2	25.8	21.1
Exports to MERCOSUR (2)	4,127	5,101	7,190	10,062	12,049	14,199	17,075	20,546	20,322	15,162	17,710	15,298	10,197	12,709	17,319	21,406
Percentage of annual growth	7.6	23.6	41	39.9	19.7	17.8	20.3	20.3	–1.1	–25.4	16.8	–13.6	–33.3	24.6	36.3	23.6
Percentage of intra-MERCOSUR exports (2:1)	8.9	11.1	14.2	18.5	19.5	20.2	22.9	24.9	25.3	19.9	20.7	17.2	11.4	11.9	12.9	13.2
Central American Common Market (CACM)																
Total exports[a] (1)	4,480	4,730	5,427	6,236	7,470	8,745	10,652	12,768	14,987	15,791	16,624	16,328	17,006	11,288	12,467	14,163
Percentage of annual growth	25.2	5.6	14.7	14.9	19.8	17.1	21.8	19.9	17.4	5.4	5.3	–1.8	4.1	11.0	10.5	13.6
Exports to CACM (2)	624	812	1,076	1,138	1,326	1,594	1,388	1,559	1,944	2,010	2,616	2,829	2,871	3,077	3,472	4,064
Percentage of annual growth	8.9	30.1	32.5	5.8	16.5	20.2	–12.9	12.4	24.6	3.4	30.2	8.1	1.5	7.2	12.9	17.0
Percentage of intra-CACM exports (2:1)	13.9	17.2	19.8	18.3	17.8	18.2	13.0	12.2	13.0	12.7	15.7	17.3	16.9	27.3	27.9	28.7
Caribbean Community (CARICOM)																
Total exports (1)	4,118	4,034	3,958	3,779	4,471	5,598	5,683	5,861	4,790	5,170	6,358	6,072	5,732	6,712	7,880	…
Percentage of annual growth	11.6	–2	–1.9	–4.5	18.3	25.2	1.5	3.1	–18.3	7.9	23	–4.5	–5.6	17.1	17.4	…
Exports to CARICOM (2)	509	458	463	536	666	843	875	976	1,031	1,096	1,230	1,384	1,220	1,419	1,810	…
Percentage of annual growth	*2.9*	–10.1	1.1	15.9	24.2	26.5	3.9	11.5	5.7	6.3	12.3	12.4	–11.8	16.3	27.5	…
Percentage of intra-CARICOM exports (2:1)	12.4	11.3	11.7	14.2	14.9	15.1	15.4	16.7	21.5	21.2	19.4	22.8	21.3	21.1	23.0	…
Latin America and the Caribbean																
Total exports[b] (1)	130,214	126,818	131,731	140,903	187,987	227,922	253,921	283,632	280,065	292,919	359,396	345,484	347,610	376,590	461,323	548,975
Percentage of annual growth	19.7	–2.6	3.9	7	33.4	21.2	11.4	11.7	–1.3	4.6	22.7	–3.9	0.6	8.3	22.5	20.0
Exports to Latin America and the Caribbean[c] (2)	18,727	20,788	24,931	29,669	36,552	45,180	53,156	59,731	56,644	48,483	62,552	58,607	53,424	59,635	79,484	100,016
Percentage of annual growth	8.2	11.0	19.9	19	23.2	23.6	17.7	12.4	–5.2	–14.4	29	–6.3	–8.8	10.8	33.3	25.8
Percentage of intra-regional exports/Total (2:1)	13.9	16.4	18.9	21.1	19.4	19.8	20.9	21.1	20.2	16.6	17.4	17.0	15.4	15.8	17.2	18.2

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official information from respective regional groupings and from the International Monetary Fund (IMF), *Direction of Trade Statistics*.

Notes

a Figures do not include maquila exports.

b Includes Latin American Integration Association (LAIA), CACM, all countries of CARICOM, Panama, Cuba and the Dominican Republic.

c Combines intra-group trade (Andean Community, MERCOSUR, CACM, CARICOM and exports from Chile and Mexico to LAIA) as well as trade between groups, plus the flow of exports from Cuba, Panama and the Dominican Republic to the other countries of the region.

Table 10.2 Structure of exports of principal subregional integration schemes in Latin America and the Caribbean, 2005 (percentages of total exports)

	Intra-group	*Other LAC countries*[a]	*United States*	*European Union*	*Asia (including Japan)*	*Other countries*
MERCOSUR	13.2	15.5	16.5	20.4	17.6	16.8
Andean Community	9.6	16.8	50.3	10.7	6.1	6.5
Central American Common Market[b]	18.6	7.2	56.2	9.5	6.7	1.8
Caribbean Community[c]	17.1	3.9	51.7	14.5	3.1	9.7
4 Customs Unions[d]	**19.4**	**7.8**	**32.6**	**16.2**	**12.2**	**11.8**

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures from the countries.

Notes
a Latin America and the Caribbean.
b Totals used to calculate coefficient include maquila and free-zone exports.
c Includes information from five countries: Barbados, Guyana, Jamaica, Suriname, and Trinidad and Tobago (2004).
d Excluding Chile and Mexico.

integration scheme. That is not so clear, however, since the next five countries with the most trade of this sort after El Salvador are Barbados, Guatemala, Nicaragua, Paraguay and Uruguay, which are not necessarily the smallest economies in the region. If we extend the list to the ten top economies with these characteristics, we see Argentina and Colombia, which orient nearly 19 per cent of their exports to the subregional scheme, very close to Bolivia's 18 per cent. Nor is the opposite true, as the economies with the least propensity to trade with the subregional market include Brazil's, along with those of Jamaica, Peru and the Bolivarian Republic of Venezuela. In other words, the size of the economy should be just one of the variables examined when looking at intra-bloc trade relations.

In any case, these coefficients should be viewed with caution. Indeed, the larger scale of big economies, such as Brazil in MERCOSUR, the Bolivarian Republic of Venezuela in the Andean Community, and Trinidad and Tobago in CARICOM, as well as the greater specialization in natural resources of the members of the subregional schemes, make the intra-regional trade coefficient lower. In contrast, in other regions such as the European Union, intra-regional trade coefficients are higher because of greater homogeneity, economic size, and a greater incidence of intra-industrial trade in patterns of production.

The size effect is most evident in the case of Brazil. The weight of trade within the subregion is slight, as 10 per cent of exports are oriented towards MERCOSUR, but these exports still account for half of the group's exports. At the other extreme are Paraguay and Uruguay, where between one-fourth and one-third of exports are sent to MERCOSUR, and together they represent less than 10 per cent of that bloc's exports (see Table 10.4).

Table 10.3 Structure of exports from main subregional integration schemes in Latin America and the Caribbean, 2005[a] (percentages of total exports)

	Intra-group export coefficient within total exports		*Exports (2005/2004) (growth rates: percentages)*		*Propensity to export manufactured goods[b] (percentages)*	
	1998	*2005*	*Intra-subregion*	*Extra-subregion*	*Intra-subregion*	*Extra-subregion*
MERCOSUR	25.3	13.2	22.0	22.0	83.8	67.7
Andean Community	14.2	9.6	30.9	30.5	85.7	35.1
CACM	17.5	28.7	13.7	6.3	84.2	78.3
CARICOM	21.5	23.0	17.9	20.1	78.4	55.6
4 Customs Unions	**21.3**	**19.4**	**29.1**	**22.1**	**84.1**	**57.2**

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Notes

a Preliminary figures.

b Refers to the coefficient of manufactured goods exports within total exports to different areas.

Table 10.4 Southern Common Market (MERCOSUR): intra-subregional trade market share matrix, 2005 (millions of dollars and percentages of total)

2005	*Millions of dollars*					*Percentages*					*"Intra" coefficient*[a]
	Argentina	*Brazil*	*Paraguay*	*Uruguay*	*MERCOSUR*	*Argentina*	*Brazil*	*Paraguay*	*Uruguay*	*MERCOSUR*	
Argentina		6,408	576	787	7,771		29.9	2.7	3.7	36.3	19.1
Brazil	10,128		981	859	11,968	47.3		4.6	4.0	55.9	10.1
Paraguay	101	303		496	900	0.5	1.4		2.3	4.2	54.2[c]
Uruguay	262	449	55		767	1.2	2.1	0.3		3.6	22.3
MERCOSUR	10,492	7,160	1,612	2,143	21,406	49.0	33.4	7.5	10.0	100.0	13.2

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official information from Secretariat of Foreign Trade, Brazil, National Institute of Statistics and Censuses, Argentina, Central Bank of Paraguay and Central Bank of Uruguay.

Note

a The intra-regional trade coefficient is defined as the share of all intra-group exports in the group's total exports.

In the Andean Community, the intra-group trade coefficient within total exports is less than 10 per cent, after two years of consecutive reductions. The largest increase in this indicator was seen in Colombia, which in turn appears to be the country with the greatest export penetration in the subregion. Indeed, 47 per cent of exports within the Andean Community correspond to Colombia, while that country sends less than one-fifth of its total exports to that market. Peru and the Bolivarian Republic of Venezuela are not very dependent on the Andean Community market, whereas Bolivia sends nearly 20 per cent of its exports there (see Table 10.5).

The Central American Common Market is important for most of its members. With the exception of Costa Rica, it receives between 16 and 54 per cent of its member countries' exports. This stands in contrast to the Andean Community, for example, where three out of five members send less than 14 per cent of their exports to the subregional market (see Table 10.6).

Among the countries of the North American Free Trade Agreement (NAFTA), imports to the subregion are especially significant for Canada and Mexico, whose exports are highly concentrated on the United States. The latter country, in turn, also sends a major share of its exports to Canada and Mexico, which are its main trading partners (see Table 10.7). The obvious increase in the weight of trade has translated into a mutual interest among the three countries in exploring the possibility of moving towards a single market.

Regional integration: main debates and challenges

Previously it was shown that the density of intra-regional trade is low in all subregional integration schemes, and that this may be caused by multiple factors, such as infrastructure deficiencies, size of partners' economies with relation to that of the bloc, and heavily commodity-oriented exports (commodities are exported primarily to industrialized economies), as well as other reasons. Among the most decisive factors are probably the weaknesses of rules and disciplines and of the institutional framework within which integration efforts takes place, including dispute resolution mechanisms, and the absence of mechanisms for macroeconomic coordination that would help prevent major macroeconomic shocks. When significant crises have occurred, their impact on intra-group trade flows has not only been devastating, but has also sparked an hysteria from which it has been difficult to recover – as evidenced by the regional trade figures in the wake of the foreign debt crisis and of the Asian crisis, with its subregional correlate, the macroeconomic crises in Brazil and then Argentina.

In this regard, the lack of macroeconomic coordination adds a new element of vulnerability to intra-regional trade, making it markedly pro-cyclical. This means not only that trade shrinks when economic activity flags, but also that production becomes more sensitive. The reason for the latter is that these macroeconomic crises, when accompanied by devaluations, can cause drastic changes in competitiveness vis-à-vis trading partners, and such changes are more significant than the size of the tariffs that have been negotiated or the gains in

Table 10.5 Andean community: intra-subregional trade market share matrix, 2005 (millions of dollars and percentages)

2005	*Millions of dollars*						*Percentages*						*"Intra" coefficient*
	Bolivia	*Colombia*	*Ecuador*	*Peru*	*Venezuela (Bolivarian Rep. of)*	*Andean Community*	*Bolivia*	*Colombia*	*Ecuador*	*Peru*	*Venezuela (Bolivarian Rep. of)*	*Andean Community*	
Bolivia		179	3	128	159	468		2.0	0.0	1.4	1.8	5.2	18.2
Colombia	51		1,370	728	2,130	4,279	0.6		15.1	8.0	23.5	47.3	19.4
Ecuador	6	359		889	98	1,353	0.1	4.0		9.8	1.1	14.9	13.7
Peru	152	355	295		277	1,079	1.7	3.9	3.3		3.1	11.9	6.3
Venezuela (Bolivarian Republic of)	6	1,042	306	522		1,877	0.1	11.5	3.4	5.8		20.7	3.4
Andean Community	214	1,936	1,974	2,267	2,665	9,056	2.4	21.4	21.8	25.0	29.4	100.0	9.6

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official data of Andean Community.

Note
a The intra-regional trade coefficient is defined as the share of all intra-group exports in the group's total exports.

Table 10.6 Central American Common Market (CACM): intra-subregional trade market share matrix, 2005[a] (millions of dollars and percentages)

2005	*Millions of dollars*						*Percentages*						*"Intra" coefficient*[b]
	Costa Rica	*El Salvador*	*Guatemala*	*Honduras*	*Nicaragua*	*CACM*	*Costa Rica*	*El Salvador*	*Guatemala*	*Honduras*	*Nicaragua*	*CACM*	
Costa Rica		208	300	230	278	1,016		5.1	7.4	5.7	6.8	**25.0**	15.6
El Salvador	109		426	267	149	951	2.7		10.5	6.6	3.7	**23.4**	54.0
Guatemala	214	671		401	218	1,504	5.3	16.5		9.9	5.4	**37.0**	43.1
Honduras	33	133	81		49	295	0.8	3.3	2.0		1.2	**7.3**	16.7
Nicaragua	54	125	46	73		297	1.3	3.1	1.1	1.8		**7.3**	27.2
CACM	**410**	**1,136**	**853**	**972**	**693**	**4,064**	**10.1**	**28.0**	**21.0**	**23.9**	**17.1**	**100.0**	**28.7**

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official data from each country and the Permanent Secretariat of the General Treaty on Central American Economic Integration (SIECA).

Notes
a Not including exports from the maquila industry and free zones.
b The intra-regional trade coefficient is defined as the share of all intra-group exports in the group's total exports.

Table 10.7 North American Free Trade Agreement (NAFTA): intra-subregional trade market share matrix, 2005 (millions of dollars and percentages)

2005	*Millions of dollars*				*Percentages*				*"Intra" coefficient*[a]
	Canada	*United States*	*Mexico*	*NAFTA*	*Canada*	*United States*	*Mexico*	*NAFTA*	
Canada		302,551	2,733	305,284		36.7	0.3	37.0	84.9
United States	211,420		120,049	331,469	25.6		14.6	40.2	36.5
Mexico	4,234	183,563		187,797	0.5	22.3		22.8	87.8
NAFTA	**215,654**	**486,114**	**122,782**	**824,550**	**26.2**	**59.0**	**14.9**	**100.0**	**55.7**

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information from the International Monetary Fund (IMF), *Direction of Trade Statistics*.

Note

a The intra-regional trade coefficient is defined as the share of all intra-group exports in the group's total exports.

competitiveness derived from any reasonable increase in productivity. Therefore, these crises activate potential conflicts between partners just when the domestic market is depressed. Sometimes the onslaught of imports from neighbouring countries unleashes protectionist reactions that lead to the adoption of measures for which there are no agreed provisions (such as safeguards, administrative quotas and a variety of non-tariff barriers related to sanitary, phytosanitary or technical standards) or simply to the unilateral suspension of the tariff preferences that had been agreed upon. If these cycles are also recurrent, it is foreseeable that integration efforts will lose credibility in the eyes of economic actors, and therefore it will be increasingly difficult to expect major investment initiatives involving integration schemes.

The main issue to address in subregional integration schemes is legal certainty for the decisions of exporters, importers and investors. This means that steady progress must be made on incorporating decisions into domestic legislation and on the enforcement of these determinations. Moreover, only realistic decisions should be approved – that is, ones that can actually be incorporated into domestic legislation. In addition, dispute resolution mechanisms must be increasingly binding, which demands a serious political commitment on the part of member countries – governments and legislatures alike – in order to abide by the rulings of the bodies that mediate trade disputes between partners.

Thus, macroeconomic coordination and the institutional framework of integration are highly complementary, since advances in each of these areas have a favourable impact on the other, prompting virtuous circles of behaviour among agents that enhance their practical commitment to integration. In contrast, weak institutions and a lack of macroeconomic coordination guarantee that integration will continue to move at a snail's pace, failing to meet the competitiveness and innovation challenges posed by today's world.

Strengthening institutions

The region urgently needs to address the shortcomings of its integration institutions. The first priority is to enforce agreements. This means that customs unions must function as such; that agreed-upon preferences must be honoured; that progress must be made towards drafting common regulations; and, fundamentally, that dispute resolution mechanisms must be strengthened. There is no doubt that greater legal certainty must be provided for all decisions made by economic agents involved in the subregional integration schemes.

Customs unions are not yet fully operating – especially in the cases of MERCOSUR, the Andean Community and CARICOM, and to a lesser extent in CACM – so in practice these are really "imperfect" customs unions. There are still "perforations" in the common external tariff (CET), both within schemes (in the form of lists of exceptions, special trade regimes including partial or total tariff exemptions, specific duties, and trade defence practices) and outside schemes (through special regimes such as capital goods, or though preferential trade agreements with third countries). All of this makes it very difficult for eco-

nomic actors to know the real level of protection that is in place. Furthermore, the application of sometimes excessive trade defence practices (safeguards, antidumping and compensatory duties) for exports within the communities poses serious obstacles to free circulation within blocs.

Harmonization and convergence of disciplines

Once compliance with the agreed-upon regulations has been achieved, the natural next step is to expand the universe of partners committed to compliance. In that regard, one underestimated factor in regional competitiveness is the gain associated with a gradual harmonization and convergence of the various rules and disciplines contemplated in the existing subregional integration schemes.

It is well known that the multiplicity of rules of origin and their extreme complexity can hinder the business sector by adding administrative and transaction costs that distort economic decisions. In this connection, an innovative feature in the Free Trade Treaty between the Dominican Republic, Central America and the United States (DR-CAFTA) is the possibility of "accumulating rules of origin" in some textile categories; in other words, inputs that qualify under the rules of origin can come from each of the five signatory States in Central America, from the Dominican Republic, or from Canada, Mexico or the United States. This is an appropriate approach that should be expanded to other agreements. Similarly, if MERCOSUR and the Andean Community are already joined by a trade agreement, and each member state has an agreement with Chile, then a great effort should be made to regionalize the rules of origin, making them multilateral for all of the countries involved; this would give a considerable boost to intra-regional trade and investment decisions. Moreover, the countries in the region that have trade agreements with the United States and that also have agreements among themselves could also move towards making their rules of origin multilateral. Such a move clearly creates more trade, improves interconnection between agreements and pushes towards the building blocks of liberalization, reinforcing the compatibility of free trade agreements with multilateral regulations.

The regionalization of rules of origin and the mutual recognition of technical, sanitary and phytosanitary regulations, together with common rules and disciplines between agreements, would send a strong signal of substantial progress towards the formation of a unified market, not only stimulating domestic investment but also enhancing the attractiveness of the region for foreign investment. It would also create special opportunities for local producers, encourage businesses in the subregions to form associations and, above all, contribute to the development of border areas. These processes would facilitate the learning process that businesses must undergo, forging strategic alliances to maintain and reinforce competitiveness.

If the main economic actors believe that one of the major weaknesses of integration schemes is legal uncertainty surrounding the decisions made by exporters, importers and investors, it is likely that, in this regard, the most

profitable investment is an investment in credibility. Hence the need to strengthen rules and disciplines, including dispute settlement mechanisms.

If the South American Community of Nations were to give priority to these issues – harmonization of rules of origin, mutual recognition of sanitary, phytosanitary and technical regulations, along with the unification of rules and disciplines and a stronger dispute settlement system – they would fill a critical need and make a substantial contribution to the creation of growth opportunities. One additional proposal that could be explored is the creation of a regional dispute settlement system and forum, based on the regulations and procedures of the World Trade Organization (WTO) in a kind of regional decentralization of that multilateral body. Not only would this eliminate the current duality of dispute resolution (with one serious and binding system, that of the WTO, and another less strict one, the regional body), but it would also allow intra-regional trade disputes, which are more numerous, to be resolved within the region itself.

Macroeconomic coordination

In this respect, one of the main challenges is coordination – and later convergence – in defining and carrying out currency, monetary and fiscal policies. A major convergence of these policies would result in increased flows of trade at the subregional level, reducing volatility and bilateral imbalances and thereby boosting demand and spurring an interest in improving the coordination and consolidation of associated institutions.[2]

The essence of the discussion lies in whether macroeconomic coordination is necessary as a complement to trade integration. The answer is not entirely obvious during the current phases of subregional integration, although in the medium and long terms it is unequivocally in the affirmative. Among the various positions that have been taken are, at one extreme, those promoting close coordination, including convergence in a monetary union with the dollar as the common currency (Lafer, 2000), or convergence on the basis of flotation; and at the other extreme, those claiming that coordination is not necessary because the critical mass of trade does not exist, nor is there any monetary authority or central bank with the reputation necessary to provide leadership in the process.[3] In the middle are those who recognize the difficulties pointed out and propose a "minimum" degree of cooperation in the coordination of macroeconomic policy (Machinea, 2004; Machinea and Rozenwurcel, 2005). The idea is to coordinate both fiscal and monetary policies by strengthening national fiscal, monetary and regulatory institutions. In addition, quantifiable goals are proposed with respect to fiscal balances, inflation, current account deficit, public debt and other indicators, as well as mechanisms to offset the effects of abrupt changes in trade flows due to external disturbances. All of this would be accompanied by a system of incentives (Machinea, 2004; Agosín, 2005) to encourage compliance with the agreed-upon coordination with a view to stimulating demand through coordination.

Because coordination is of such vital importance for the development of

regional integration, it can be argued that "exogenous" incentives, such as the fixed exchange rate system the Europeans inherited from Bretton Woods, are one possibility. Lacking a similar incentive in our region, it is reasonable to postulate that multilateral organizations such as the World Bank and the Inter-American Development Bank (IDB), or subregional entities such as the Andean Development Corporation (ADC) and the Central American Bank for Economic Integration (CABEI), could create positive incentives.

At present, the countries of MERCOSUR have achieved convergence with respect to the growth cycle, currency flotation schemes, fiscal results, the application of anti-inflation policies, and a significant reduction of debt as a percentage of GDP, especially in Brazil and Uruguay (see Table 10.8). In the Central American Common Market and the Andean Community, the extreme cases of Nicaragua and the Bolivarian Republic of Venezuela have raised the averages.[4] Nevertheless, the figures reflect a noteworthy period in the region's macroeconomic accounts, with significant progress in controlling inflation and budget deficits. The favourable external cycle in 2004–2005 explains much of this success, but officials have failed to take advantage of the positive circumstances to move forward on macroeconomic coordination schemes that would cushion the impact of future external shocks or prevent the subregions themselves from generating macroeconomic turbulence.

Regional integration in Latin America: debates and challenges

MERCOSUR

MERCOSUR's political prominence increasing

MERCOSUR has been expanding its role as a means for political synchronization and coordination in South America, among the member states, with associated countries and with Mexico, which has expressed an interest in associating itself with this subregional integration scheme. The trade agreement between MERCOSUR and the Andean Community and the negotiation of one with the South American Community of Nations are manifestations of this trend.

This upbeat political juncture also coincides with a favourable economic cycle. In this regard, MERCOSUR is seeing the convergence of an expansive economic cycle, a major currency and monetary alignment, positive fiscal balances and less currency and financial volatility. The positive macroeconomic results that Brazil is achieving and the successful renegotiation of Argentina's debt provide further cause for optimism.

Thus, MERCOSUR is in a good position to take advantage of the notable political convergence of the current presidents of its member countries and their emphasis on strengthening the subregional organization. The international political and economic climate is propitious for bold initiatives for economic integration and cooperation. The recent association with Colombia, Ecuador and the

Table 10.8 Subregional integration schemes: comparison of selected macroeconomic convergence indicators, 2002 and 2005

Country/Indicator	*Inflation*		*Current-account deficit (% of GDP)*		*Public deficit (% of GDP)*		*Public debt (% of GDP)*	
	2002	*2005*	*2002*	*2005*	*2002*	*2005*	*2002*	*2005*
Targets	*5% in 2006*		...		*–3% of PIB*		*40% in 2010*	
Southern Common Market (MERCOSUR)[a]	**17.8**	**7.4**	**0.4**	**1.9**	**1.9**	**–1.1**	**64.6**	**39.8**
Argentina	41.0	12.0	9.4	2.5	–0.3	1.3	131.5	71.4
Brazil	12.5	6.2	–1.7	1.9	2.6	–1.7	49.4	30.5
Paraguay	14.6	12.3	1.4	–2.3	–0.4	–0.5	51.2	41.6
Uruguay	25.9	4.8	2.6	–1.2	–4.9	–0.8	85.9	80.1
Targets	*10% each country*		...		*–4% of GDP*		*50% of GDP*	
Andean Community[a]	**10.0**	**6.7**	**1.3**	**7.1**	**–3.6**	**–2.7**	**45.7**	**40.3**
Bolivia	4.9	5.0	–4.5	0.5	–9.0	–3.5	55.1	52.7
Colombia	5.8	5.1	–1.8	–0.3	–5.0	–5.5	46.3	36.5
Ecuador	2.0	3.8	–5.6	–0.4	–0.8	–1.4	66.8	56.4
Peru	4.1	1.1	–2.0	1.7	–2.1	–1.2	49.3	41.6
Venezuela (Bolivarian Rep. of)	19.5	15.3	8.0	19.2	–3.5	–1.5	36.8	37.7
Target	*4% each country*		*–3.5% of GDP*		*–2.5% of GDP*		*50% of GDP*	
Central American Common Market (CACM)[a]	**6.5**	**9.4**	**–5.6**	**–4.2**	**–2.9**	**–3.1**	**51.1**	**39.8**
Costa Rica	9.7	14.2	–5.4	–5.1	–4.3	–2.8	56.0	19.0
El Salvador	2.8	4.6	–2.9	–3.9	–3.1	–2.9	46.0	30.4
Guatemala	6.3	9.2	–5.3	1.5	–1.0	–1.8	28.0	13.6
Honduras	8.1	7.7	–3.3	–5.7	–5.2	–3.0	67.8	71.5
Nicaragua	4.0	10.5	–21.7	–17.3	–4.1	–2.0	155.0	111.4
3 groups[a]	14.7	7.3	0.2	2.6	0.0	–1.3	58.1	33.3

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures and Central American Monetary Council.

Note

a Averages weighted by each country's GDP.

Bolivarian Republic of Venezuela, prior agreements to associate with Peru, Bolivia and Chile, and Mexico's interest in associating with MERCOSUR, all reveal an unprecedented constellation of convergences between MERCOSUR, Chile, the Andean countries and Mexico.

In this new situation, with the addition of Mexico, MERCOSUR will have six associate members and four full members. After Mexico joins, the associate countries' GDPs will be 40 per cent higher than those of full members and will account for 58 per cent of the expanded GDP, while their total exports will be 2.2 times those of the full members. MERCOSUR's growing importance as a political forum does not, therefore, assure it of corresponding economic and commercial influence. In fact, MERCOSUR's greater political relevance has been accompanied by an unprecedented amount of criticism – at the highest level – of its performance as a customs union.

In addition to considering the high relative profile of associate members, which are by definition outside the customs union, we should also note the diversity of approaches to trade policy. In a few months, the associates may include five countries (Colombia, Chile, Ecuador, Mexico and Peru), and possibly six if Bolivia makes the move, that have signed bilateral accords with the United States. The differences in coverage and scope of the respective agreements – between those with the United States and those with MERCOSUR – pose a particular challenge for the integration mechanisms.

MERCOSUR facing a credibility test

This subregional entity is currently facing a test of its credibility and objectives. Its founding protocol, signed in Ouro Preto in 1994, defines it as a customs union, which assumes free trade within the zone, a common external tariff and a common external trade policy. Eleven years later that objective is far from being attained, and the prospects for the future are complex. There are still too many tariff exceptions: with respect to both the intra-zone zero tariff and the common external tariff, advances in technical and tariff harmonization have been smaller than expected. Moreover, since the late 1990s new exceptional treatment plans have been introduced – sometimes by consensus, sometimes unilaterally – that undermine these principles (Kosacoff, 2005).

Trade preferences that were negotiated have been undermined by unilateral decisions using measures not always consistent with the standards agreed upon by the member states. In turn, regulations approved by the members have not been translated into domestic legislation, which widens the gap between community rules and public policies actually adopted by the nations within the community, further complicating the future convergence of public policies. Inconsistencies cause delays in strategic decision-making, and eventually hinder domestic consensus-building, thereby creating additional difficulties for convergence in integration processes, which paves the way for future non-compliance with community rules. This is why the definition of differences in MERCOSUR today is so critical for the future of the community.

In recent years, trade disputes between Argentina and Brazil at the ministerial level and between the respective business groups have made the headlines. Many different sectors of production are involved: Argentina has complained about the damage caused by Brazil's exports of textiles, footwear, televisions, household appliances, batteries, wooden furniture, cotton, yarn, denim and rugs, while Brazil alleges that Argentine products are hurting its chicken, dairy, wheat, rice and sugar industries.

Argentine authorities point to the imbalance in accounts that is suddenly favouring Brazil, claiming that it is due to the failure to honour commitments made under the Asunción Treaty aimed at coordinating macroeconomic policies and establishing integrated investment policies to create intra-regional production chains, thereby making MERCOSUR more competitive in other markets. Because these commitments have not resulted in integrated investment policies, Argentine authorities have proposed unilaterally employing provisional compensation mechanisms while waiting for macroeconomic harmonization to take place or for the sectors benefiting from these protective measures to make investments to improve their competitiveness. Among the mechanisms involved are quotas negotiated directly between private parties, safeguards or different types of import licences. In a later discussion, safeguards were rejected and the Brazilian representatives relaxed their stance, expressing a willingness to finance Argentine exports to Brazil as soon as Argentina reinstates the common external tariff (CET) of 14 per cent for machinery and tools, which limits Argentina's market for these exports.

In early July 2005, Brazil's representatives formally agreed to discuss a competitive adaptation clause in MERCOSUR "similar to safeguards" (*La Nación*, 9 July 2005), and this mechanism was finally agreed on February 2006. On the other hand, Brazil insisted that the possibility of a private agreement should be given a chance before turning to this mechanism. In other words, quotas and voluntary export restrictions could be negotiated. One persistent difficulty is that this potential clause is associated with "major macroeconomic alterations", a situation that does not now exist. Therefore, it could not be applied to the numerous controversies currently going on.

Argentina's response is that incentive mechanisms to encourage productive investment should also be discussed to ensure that they do not harm trade. The idea, according to Argentine authorities, is not to eliminate the incentives, but to guarantee equal treatment. Although the precise methodology has not been revealed, the impression is that an attempt would be made to quantify the effect of these incentives on prices, and then to adjust the trade preferences that are granted in order to prevent spurious competition that might result from them.

The debate within MERCOSUR also highlights the weakness of the dispute settlement mechanisms. Without legal certainty or a strong record of honouring commitment deadlines there is also a disincentive for compliance, and on the contrary there is an incentive for individual sectors to demand additional exceptions or delays in fulfilling their obligations. In short, the signals are not encouraging for investments in subregional integration. This attitude deters the most

entrepreneurial business leaders and leads them to explore other options – including, to be sure, measures aimed at improving the customs union, but also the possibility of creating a free trade zone.

Regarding disputes settlement, between 1995 and 2005 there were 513 consultations, dealing with standards and technical regulations (22 per cent), discrimination and tax measures (which includes tax discrimination) (22 per cent), export duties, financing of imports, export subsidies and specific duties. They are followed by tariff preferences (14 per cent), licences and prohibition of imports (10 per cent) and items grouped together as measures for trade facilitation (9 per cent), among others. The sector most severely affected is the food industry (36 per cent), followed by other manufacturing (31 per cent), especially metalworking, chemicals, and the textile industry (MERCOSUR Secretariat, 2004; Durán and Maldonado, 2005; Table 10.9).

The main conclusion to be drawn from this type of analysis is that non-tariff barriers predominate: a clear threat to the establishment of a free trade zone. Countries must move towards the harmonization of their rules, especially regulations and standards, and must also limit the application of sectoral exceptions. One allegation made by Argentine producers is that Brazil's mechanisms to boost production and support exporters exacerbate the size asymmetry, making it less likely that other MERCOSUR partners will be able to attract investment for exports to the Brazilian market. They thus complain that an additional distortion remains in place, and so far the group has not taken adequate steps to compensate for it (Bouzas, 2004; Delgado, 2004).

The relatively smaller countries have renewed their complaints that they do not have effective access to the larger markets, which makes it hard for them to attract investments that would come with access to a broader market. There are also allegations of non-compliance with a common investment policy promoting the coordination of production in MERCOSUR and creating competitive advantages for exports to other markets. Another complaint is that larger countries are still subsidizing investment, making it even more difficult for smaller economies to attract investment. And finally, the failure to make progress on macroeconomic coordination also costs these economies dearly, as they have absorbed without any compensation the effects of the larger economies' macroeconomic crises. In other words, not only are the size asymmetries among the MERCOSUR partners not being addressed adequately, but they are also being aggravated by the lack of macroeconomic coordination between the larger economies and by the persistence of tax incentives for investment and export promotion in these economies, which distorts relative competitiveness.

Lastly, there are allegations of a failure to meet the timetable of commitments under the Asunción Treaty to undertake trade negotiations for services, investment, public procurement, macroeconomic coordination and integration of production chains.

MERCOSUR's prospects

One initial conclusion is that the political convergence of the current leaders of Argentina and Brazil, who pledged to strengthen MERCOSUR, has not only failed to achieve results but also coincided with perhaps the worst juncture for this subregional organization (Candia Veiga, 2005). The current crisis is reviving the principal dilemmas facing the entity: (i) the dilemma of customs union versus free trade zone; (ii) the ambiguity between community institutions and inter-government agreements; (iii) economic asymmetries; and (iv) sectoral asymmetries (Onuki, 2004).

In addition to the well-known difficulties suffered by MERCOSUR, there is a growing gap between the diplomatic importance this body has for Brazil and its importance in the realm of trade (Markwald, 2005). The result is a dynamic inconsistency between the positions of its member states. On the one hand, the expectation that Brazil would serve as an engine for the growth of exports from Argentina, Paraguay and Uruguay has not been fulfilled, nor have these exports become more diversified. On the other hand, as Brazil becomes more competitive, the subregional area loses its value for the development of Brazil's export sector. However, Brazil needs MERCOSUR as a platform for its international diplomatic efforts, both in the multilateral arena (WTO talks, G20), and at the hemispheric level (Free Trade Area of the Americas, FTAA); for building leadership among developing countries (relations with China, India, South Africa and the Arab economies), and for its attempt to promote a round of

Table 10.9 Testing the Dispute Settlements Mechanism in three integration schemes

Integration scheme	*Four most frequent consultations*	*Share in total*	*Cumulative cases*
MERCOSUR (1995–2005)	Standards and technical rules (22%), discrimination and tax measures (22%), export duties, financing of imports, export subsidies and specific duties, tariff preferences violations (14%), licenses and prohibition of imports (10%)	70%	513
Andean Community (1997–2005)	Violations of the common external tariff (19%), antidumping (13%), safeguards (11%) and measures violating Andean Community regulations (10%)	53%	480
Central American Common Market (2003–2005)	Sanitary and phytosanitary measures and rules of origin violations	75%	8

Source: Durán and Maldonado (2005).

South–South negotiations to promote the Global System of Trade Preferences (GSTP) among developing countries.

An effectively open regionalism, with a lower CET and a declining trend in tariffs, will make it possible to resist unilateral protectionist temptations, reinforcing the commitment to free trade and also making more room for trade negotiations between MERCOSUR and external partners such as the European Union.

Andean community

The Andean Community Commission, at a meeting in March 2005, adopted a working plan designed to expand the integration of trade, with the following elements:

- Permission for the free circulation of goods and services, basically by detecting and removing barriers to access; regulating Andean Community safeguards; simplifying and harmonizing customs procedures; harmonizing technical, sanitary and phytosanitary standards; establishing automatic recognition practices; and eliminating measures that have no technical support, along with liberalizing professional services;
- Promotion of a customs union, adopting a CET and agreeing on a farm price stabilization system;
- Reinforcement of the dispute resolution system, incorporating arbitration between private parties and improving the enforcement provisions of rulings;
- Establishment of a joint investment and production development plan, especially with respect to energy and agroindustry, moving towards a system of guarantees for SMEs;
- The fostering special support programmes for Bolivia and Ecuador, ensuring that the Andean Community process yields balanced benefits and addresses the most obvious asymmetries.

A special issue for this community organization is the fact that three of its members (Colombia, Ecuador and Peru) have concluded or are engaged in free trade negotiations with the United States. These agreements will result in commitments that are considerably broader and deeper than those the member states have with each other. In other words, in the coming years, barring decisive action to update the Andean Community regulations governing goods, services, investments and trade disciplines, integration may take place on two levels, with the community level being the less intense. Needless to say, if this duality grows the business climate will gradually turn towards the schemes with more far-reaching provisions and more binding dispute settlement mechanisms. In this regard, these negotiations offer the Andean Community a great opportunity to update its procedures, something that the annotated working plan calls for. This plan is certainly the minimum necessary to move in the right direction, and the pace will have to quicken if this effort is to keep up with the new commitments.[5]

On 1 January 2005, the Andean Community–MERCOSUR and Peru–MERCOSUR free trade agreements took effect, immediately freeing up 80 per cent of the trade between the two blocs. The remaining 20 per cent, including sensitive products, will be freed over the next fourteen years.

An analysis of the Dispute Settlements Mechanism of the Andean Community[6] determines that, between 1997 and 2005, 486 "opinions" were issued, of which approximately 22 per cent were on cases filed by the SGCAN on its own initiative.[7] Colombia and Peru made the most use of this mechanism, whereas Bolivia filed the smallest number of complaints. After the General Secretariat itself, Colombia, Ecuador and Venezuela are the countries with the most complaints filed against them. As for the agreements or regulations alleged to have been violated, during the same period (1997–2005) violations of the common external tariff (CET) appear to be the most common allegation, with eighty-nine complaints (19 per cent of the total). That category is followed by opinions issued on violations of antidumping, safeguards and measures violating Andean Community regulations, with 13 per cent, 12 per cent and 10 per cent of the total, respectively. These four types of measures combined account for 54 per cent of all opinions issued by SGCAN in the entire period (see Table 10.9).

Between 1995 and June 2005, 172 complaints were filed alleging non-compliance, of which 135 (78.4 per cent) had been remedied and thirty-seven (21.5 per cent) remained unresolved as of 13 July 2005. The countries against which the most complaints were filed were the Bolivarian Republic of Venezuela and Ecuador, and these were also the two countries with the largest number of unresolved cases (thirteen and twelve, respectively). In the opinion of the SGCAN, "non-compliance by member states is still of concern" (SGCAN, 2004).

Free trade agreement between Central America, the Dominican Republic and the United States (DR-CAFTA): a noteworthy accord

Trade with the United States is the most important for the Central American subregion, and since 2000 it has been governed by the Caribbean Basin–United States Trade Partnership Act, due to expire in 2008. The negotiations for a free trade agreement began in January 2003 as part of a regional objective of increasing exports to the United States market and also attracting investment in the subregion. By the middle of December 2003, El Salvador, Guatemala, Honduras and Nicaragua had concluded the negotiation of their free trade agreement with the United States; they were followed by Costa Rica in January 2004. During that time, there were nine rounds of talks in six groups: market access, services and investment, public sector procurement and intellectual property, environment and labour issues, dispute resolution, and institutional matters. The Dominican Republic joined the Treaty in March 2004.

El Salvador ratified the treaty in December 2004, and Honduras and Guatemala did so in April 2005. At the end of June it was ratified by the United States Congress, despite the controversy over three main issues: the sugar indus-

try, opening up the textile sector, and labour (the possible loss of jobs in the United States and the labour rights situation in Central America and the Dominican Republic). The House of Representatives voted to ratify the treaty by a slim two-vote margin (217 to 215). This agreement has not entered into force due to implementation problems, although all members concluded their ratification process, except Costa Rica.

In 2005 and also in the first quarter of 2006, before DR-CAFTA takes full effect, the countries may adopt a programme to make current CACM rules compatible with those of the new treaty, along with the rest of the bilateral agreements in place in the subregion. In addition to those already mentioned, one particularly sensitive area is rules of origin, which overlap and vary among the different agreements. This could raise transaction costs for exports from the subregion, making them less competitive and even detracting from the possible benefits that might be enjoyed under previous agreements. In any case, if the compatibility effort succeeds, DR-CAFTA will have the effect of enhancing Central American integration.

It is estimated that, on average, the treaty could boost growth in the subregion by between 0.5 per cent and 1 per cent of GDP and create between 20,000 and 25,000 jobs, as well as starting a downward trend in poverty (ECLAC, 2004a).

In mid-February 2005, the CACM countries and the Dominican Republic signed with the United States several memoranda of understanding and environmental protection agreements, among them the Environmental Cooperation Agreement. They also agreed to establish a Secretariat for Environmental Affairs, which will help implement the environmental provisions of the treaty signed by the parties (Hornbeck, 2003).

Studies show that advances in customs cooperation among CACM countries have yielded an average gain of at least 0.5 per cent of GDP (Machinea, 2004). The treaty with the United States and the Dominican Republic (DR-CAFTA) opens up the possibility of expanding the range of tariff preferences for Central American businesses by about 60 per cent of overall trade, and it could boost subregional GDP by 0.8 per cent to 2.3 per cent, with an increase in total exports of 1.6 per cent to 5.2 per cent (Hinojosa-Ojeda, 2003). Nevertheless, the two principal effects of this type of agreement must be taken into consideration: (i) regulatory consequences, and (ii) the possible diversion of intra-regional trade due to competition between subregional products and those coming from the United States.

The commitments made under DR-CAFTA differ in coverage and content from those of CACM (see Table 10.10). In practice, the commitments undertaken by these countries vis-à-vis the United States are different in magnitude and content from those prevailing in CACM. With respect to investment disputes, arbitration under the auspices of the International Centre for Settlement of Investment Disputes (ICSID) will be required; and cross-border trade in services, financial services and telecommunications will also be governed by DR-CAFTA regulations, except that Costa Rica made selective and gradual commitments in this chapter of the accord and with regard to opening up its

Table 10.10 Central American Common Market (CACM): principal topics covered in bilateral Accords signed by the subregion and comparison with current Community regulations

	Elimination of tariff escalation	*Rules of origin*	*Trade in services*	*Investment*	*Technical barriers*	*Normalization*	*Public procurement*	*Safeguards, antidumping*	*Competition policy*	*Intellectual property*	*Dispute resolution*
Central American Common Market (CACM)	✓	…	✓	✓[a]	…	✓	✓[b]	✓	…	✓	✓
DR-CAFTA[d]	✓	✓	✓	✓	✓	…	✓	✓	…	✓	✓
CACM–Chile	✓	✓	✓	✓[e]	✓	✓	…	✓	✓	…	✓
CACM–Dominican Republic	✓	✓	✓	✓	✓	…	✓	✓	✓	✓	✓
CACM–Panama	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Costa Rica–Mexico	✓	✓	✓	✓	…	✓	✓	✓	…	✓	✓
Mexico–Nicaragua	✓	✓	✓	✓	✓	✓	✓	✓	…	✓	✓
Mexico–Northern Triangle[f]	✓	✓	✓	✓	…	✓	…	✓	…	…	✓

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information from agreements concluded by countries.

Notes
a With subregional regulations ratified only by Honduras.
b With community regulations pending ratification by Honduras.
c GATT/WTO international regulations still in force.
d Free trade agreement between Central America, the Dominican Republic and the United States.
e Includes all investment protection and promotion agreements signed by Chile with the countries of the group.
f Comprises El Salvador, Guatemala and Honduras.

insurance industry. The same is true of the chapter on intellectual property, which specifies that second-use patents are not allowed.

In general, North–South bilateral agreements allow access to a broader and more stable market and lead to an increase in worldwide trade flows. In addition, a strong signal is sent to investors and business sector, since the agreements tend to be seen as irreversible processes with a major component of transparency and greater legal certainty. This results in positive externalities for the design of the signatory country's economic policy (Schiff and Winters, 2003). There may also be incidents of trade diversion within regional integration accords.

Monge-Gonzáles *et al.* (2003) determined that NAFTA did not divert intra-subregional trade for Central America, basically because the countries continued to enjoy the unilateral preferences granted under the Caribbean Basin Initiative launched by the United States Government. With DR-CAFTA the main tangible benefits will be both the consolidation of those preferences, which will become permanent instead of temporary, and the elimination of tariff escalations, which facilitates the diversification of exports. Some recent studies (Hinojosa-Ojeda, 2003; Ángel and Hernández, 2004) evaluating the effects of DR-CAFTA conclude that CACM businesses will face competition from products from the United States that will replace imports of less competitive products from the subregion (see Table 10.11). Ángel and Hernández (2004) conclude that opening up to imports from the United States leaves intra-subregional exports, valued at a total of US$1.3678 billion, in a vulnerable situation.

Diversion of trade in CACM would basically affect chemicals, agroindustrial products, the paper industry, food and fertilizer and the plastics industry (Hornbeck, 2003; ECLAC, 2003a, 2003b), which will pose a challenge for non-competitive sectors to restructure their industrial complexes, especially some SMEs. This should be viewed in the context of the expected increase in investment as the market expands and rules become more stable (Cordero, 2005).

The fiscal impact should also be considered. The elimination of tariffs entails a decline in tax revenues, which is expected to be major in Honduras (nearly 5 per cent of revenues), less significant in Costa Rica and Nicaragua (less than 2 per cent) and much smaller in Guatemala and Nicaragua (under 0.5 per cent of total tax revenues). As for GDP, Honduras will again suffer the greatest losses (between 0.82 per cent and 1.59 per cent of GDP) (Barreix *et al.*, 2004; Paunovic, 2004, respectively).

Final remarks

The multiplicity of levels at which negotiations are taking place and the large number of decisions that must be adopted at those different levels require a clear internal consensus regarding priorities, improving trade-policy making and consistency that must be maintained among the various domestic public policies that come into play in the international sphere.

Regarding improving policy mix, more and more bilateral trade agreements are being negotiated at the same time with partners both inside and outside the

Table 10.11 Central American Common Market (CACM): competition in the intra-subregional market after the signing of DR-CAFTA: possible diversion of intra-subregional trade (percentage changes in exports from base year = 1997)

Origin/Destination	*Costa Rica*	*El Salvador*	*Guatemala*	*Honduras*	*Nicaragua*	*United States*	*Mexico*	*Rest of the world*	*World*[b]
Costa Rica[a]		–0.17	–0.17	2.47	–0.46	0.39	0.49	2.16	**1.56**
El Salvador[b]	–0.48		0.31	–0.12	0.37	3.62		4.17	**3.55**
Guatemala[a]	–0.28	–1.67		–0.15	–1.84	2.73	1.71	2.29	**5.24**
Honduras[a]	1.26	–0.23	–0.26		–0.52	0.44	0.44	3.18	**1.72**
Nicaragua[b]	–0.76	–0.63	–0.58	–1.14		2.01	6.54	2.36	**2.26**
Mexico[b]	7.73	–0.71	–0.50	–1.83	0.59	3.61		19.56	**7.27**
United States[b]	**7.56**	**11.28**	**12.01**	**2.58**	**16.53**		**3.51**	**–0.14**	**0.37**

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Raúl A. Hinojosa-Ojeda, *Regional Integration Among the Unequal: A CGE Model of US-CAFTA, NAFTA and the Central American Common Market*, Los Angeles, University of California, 2003.

Notes

a Results of a Computable General Equilibrium (CGE) model that includes static effects.

b Results of a CGE model that includes dynamic effects and complete mobility of labor (migration).

region, making it necessary to reinforce consistency among trade policies at different levels: multilateral, hemispheric, subregional, bilateral and unilateral.

Intra-regional trade is low in all subregional integration schemes. This may be caused by multiple factors, such as infrastructure deficiencies, size of partners' economies with relation to that of the bloc, and heavily commodity-oriented exports (commodities are exported primarily to industrialized economies), as well as other reasons. Among the most decisive factors are probably the weakness of trade disciplines and the institutional framework within which integration efforts are taking place, including dispute settlement mechanisms, and the absence of mechanisms for macroeconomic coordination that would help manage major macroeconomic shocks.

The main issue to address in subregional integration schemes is legal certainty for the decisions of exporters, importers and investors. This means that steady progress must be made on incorporating trade disciplines into domestic legislation and on the enforcement of these. Regarding the latter, dispute settlement mechanisms must be increasingly binding, which demands a serious political commitment on the part of member countries.

The Latin American region urgently needs to address the shortcomings of its integration institutions and convergence of trade rules to enhance interconnection among bilateral/regional trade agreements. The first priority is to enforce agreements, the second is development of improved rules and disciplines that govern trade among countries, and the third is to promote convergence among trade disciplines in order to improve their quality and promote further trade.

Notes

1 This paper is based on Chapter III of *Latin America and the Caribbean in the World Economy 2004 Trends 2005*, available at www.cepal.org/cgi-bin/getProd.asp?xml=/publicaciones/xml/0/22470/P22470.xml&xsl=/comercio/tpl-i/p9f.xsl&base=/comercio/tpl/top-bottom.xsl. The views expressed in this document, which has been reproduced without formal editing, are those of the authors and do not necessarily reflect the views of the ECLAC.

2 This is not a minor issue, as negative trade balances promote protectionist behaviours in the search for alternative trade defence mechanisms, a less likely scenario in balanced trade environments.

3 Studies advocating convergence on the basis of flotation include those of Giambiagi, 1999; Lafer, 2000; Eichengreen and Hausmann, 1999; and Lorenzo *et al.*, 2004, among others.

4 The General Secretariat of the Andean Community in march 2004 prepared a follow-Up Report that reviews the situation in each Member State. The preliminary results for 2003 and 2004 indicate that the Bolivarian Republic of Venezuela, with an inflation rate of 19.2 per cent, still cannot meet the target of 10 per cent, while Bolivia still has a public deficit higher than the target of 4 per cent of GDP. Its debt level of nearly 80 per cent also exceeds the established threshold (50 per cent).

5 For example, in the Free Trade Agreement with the United States, the three above-mentioned Andean nations will have to grant national treatment to investments and services from the United States, and will have to do the same in public procurement. Such treatment is clearly superior to that accorded by the Andean Community members in the same areas.

6 According to Decision 425, the SGCAN shall, on its own initiative or at the request of a country, conduct investigations to determine whether a violation took place and shall issue an opinion explaining its reasoning; notice of any representations made shall be given to the member state alleged to be in violation. If after the SGCAN report a member maintains the non-conforming measure, the case goes to the Andean Justice Tribunal.

7 Many of these decisions were prompted by the interests of private parties or businesses in the respective countries.

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Part IV

Results of North American and hemispheric trade negotiations

11 Does the FTAA have a future?

Jeffrey J. Schott

The negotiation of a Free Trade Area of the Americas (FTAA), involving thirty-four democratic countries in the Western Hemisphere, has struggled to advance over the past decade. The deadline for concluding the talks passed virtually unnoticed at the start of 2005. Currently, the initiative is moribund.

As originally vetted, the FTAA is the most ambitious free trade initiative of the post-war trading system. Never before have so many countries of such widely diverse size and level of development joined together to negotiate a *reciprocal* free trade pact. Under the best of circumstances, crafting such a pact would be difficult. But negotiators have not been so lucky. Their task has been complicated by the financial crises and political turmoil that beset many Latin American participants over the past decade, the new security imperatives of the post-9/11 world, and now the prospective expiry of US trade promotion authority in June 2007.

Can the FTAA negotiations be revived? As government leaders prepare for the next Summit of the Americas in Mar del Plata, Argentina, in November 2005, the unbridled optimism evidenced at their previous summit in Quebec City in 2001 seems to have given way to rampant pessimism. Many countries seem distracted by pressing economic and political problems at home; all face the challenge of adjusting to rapidly changing conditions in the global economy generated by technological innovation and by the emergence of the Chinese trading juggernaut. Not surprisingly, questions have been raised as to whether governments can fulfill their lofty Summit promises – or whether they even still want to do so.

This short paper examines the current status of the FTAA negotiations and posits what needs to be done to get the talks back on track. To better understand the current negotiating stakes, I first briefly discuss the historical factors that precipitated the hemisphere-wide trade initiative.

Why did countries want an FTAA?

Why did the countries of Latin America and the Caribbean (LAC) reverse decades of antipathy to formal trade ties with United States and support – and in some cases actively lobby for – a free trade deal with the world's industrial

superpower? The answer is complex, and requires more analysis than can be devoted in this short paper. However, in most cases the policy reversal reflected a sea change in national economic policies and development strategies caused by the failure of the import-substitution model of development of the 1960s and 1970s, the collapse of debt finance in the wake of the Latin American debt crisis of the 1980s, and the inexorable competitive pressures emanating from the advance of globalization.

Why did the United States promote the idea of an FTAA with the LAC region? Visions of a hemisphere-wide free trade zone were expounded by Ronald Reagan a generation ago, but were shunted aside during the lost decade of the 1980s as debt problems, high levels of trade protection, civil strife, corruption, and autocratic rule in the LAC region burdened US–Latin American relations. About fifteen years went by until Reagan's ideological antipode, Bill Clinton, revived the vision as the centerpiece of a renewed summitry initiative.[1]

While Ronald Reagan may have put the vision of hemispheric free trade into words, the leaders of Mexico deserve credit for taking decisions that provoked other LAC countries to embrace trade talks with the United States. Mexican President Miguel de la Madrid turned to economic reform in 1985 essentially because there were no other viable alternatives. Carlos Salinas followed and accelerated the reform program during his term in office. His pivotal decision to request an FTA with the United States in early 1990 can be seen as the first concrete step toward a hemispheric trade pact. Instead of slowing down the reform process to "digest" the substantial economic adjustments incurred in the 1980s, Salinas used the prospect of the FTA to accelerate the pace of economic change within Mexico and to encourage inflows of foreign direct investment (FDI). In fact, the mere announcement effect of FTA talks elicited significant new commitments of FDI in Mexico in anticipation of the new trade regime with the United States (see Hufbauer and Schott, 2005: Chapter 1).

When Mexico and the United States announced the launch of FTA negotiations in June 1990, which evolved into the NAFTA when Canada joined the talks several months later, other countries in the LAC region faced a new competitive challenge for market share in and FDI from the United States. The purpose of NAFTA for Mexico was to complement ongoing domestic reforms and create new trade and investment opportunities within the Mexican economy – some at the expense of neighboring countries. The prospective NAFTA preferences posed a real competitive threat to countries participating in the Caribbean Basin Initiative (CBI) and in the Andean Trade Preferences Act (ATPA), since their tariff preferences in the US market were both time-limited and less comprehensive than the contractual obligations granted to Mexico under NAFTA. Those countries had to either emulate the Mexican reforms – following a strategy of competitive liberalization à la Bergsten (1996) – or risk losing trade and investment to countries offering a more hospitable business climate.

The United States could not say "no" to the audacious Mexican proposal, but US officials were cognizant of the potential adverse effects the NAFTA could have on nascent economic and political reform in the LAC region. Accordingly,

President George H. W. Bush announced the "Enterprise for the Americas Initiative" (EAI) just a few weeks after the US–Mexico decision to develop an FTA. The EAI had three main pillars: trade, finance, and debt. It was designed to support the new commitment to democracy and market-oriented reforms throughout the LAC region by expanding regional trade and investment and helping to reduce national debt burdens (by augmenting the Brady Plan). Trade was the focal point of the EAI, with the ultimate goal of creating a Western Hemisphere FTA (Schott and Hufbauer, 1992).

The EAI soon was overshadowed by ongoing negotiations of the NAFTA and the Uruguay Round, and subordinated to new initiatives involving the rapidly growing nations of the Asia-Pacific Economic Cooperation (APEC) forum. The onset of annual Summit meetings of APEC leaders, starting in Seattle in November 1993, posed a sharp contrast to US relations with the LAC region. The LAC countries clamored to keep pace with APEC initiatives, especially the Bogor Declaration of November 1994 that sought free trade and investment in the Asia-Pacific by 2010/2020 for developed/developing countries, respectively. To its credit, the Clinton administration subsequently proposed a new Summit of the Americas to parallel the APEC process. The resulting meeting in Miami in December 1994 echoed the APEC commitment to free trade and investment issued three weeks earlier with the mandate to negotiate a FTAA within a decade.[2]

The Summit of the Americas in Miami in December 1994 provided the original mandate for an FTAA that would progressively eliminate barriers to trade and investment in the hemisphere and targeted the completion of the negotiations no later than January 2005. After several years of consultations and preparations, the trade talks were finally launched after the Santiago Summit in April 1998. Trade ministers agreed to work on a comprehensive agenda of issues covering both market access and rule-making. Talks were organized into nine negotiating groups.[3] In addition, a consultative group on small economies was established to ensure that the concerns of the majority of the FTAA participants were reflected in the work of each group. Committees on electronic commerce and on the participation of civil society were also convened.

Seven years later, the original deadline for concluding the trade deal has passed and negotiations remain at an impasse. To date, the negotiations have produced a heavily bracketed draft text and little else. Negotiations to reduce barriers to market access for goods and services – the "guts" of any free trade pact – have barely progressed. The only positive development to report is the very modest "capacity-building" initiatives advanced by the Inter-American Development Bank and some national development agencies that have addressed critical infrastructure and administrative problems in smaller economies.

What is the FTAA really about?

The FTAA was never meant to unite the economies of the Western Hemisphere; it merely sought to eliminate barriers to trade and investment among

participating countries. To be sure, some officials projected a broader vision of the FTAA, and sought to borrow elements of the European integration model for the FTAA process, particularly the use of regional aids to promote growth in less-developed countries. Small developing economies have called for special FTAA funds to transfer resources from North America to poorer parts of the LAC region akin to the regional development grants funded by the richer, northern European countries as inducements to get new members to join the European Community. Similarly, Mexican leaders also have sought increased NADBank financing for public infrastructure projects. None of these countries, however, buys into the political side of the European bargain – the ceding of sovereignty to supra-regional bodies – since in the Western Hemisphere context that would translate into US hegemony over the LAC region.[4]

For that reason, the FTAA has always had a more traditional and discrete trade objective: to remove barriers to trade in goods and services between the countries of North and South America. It is not a surrogate or a channel for development aid; however, the trade and regulatory reforms implemented in response to FTAA provisions can and should be important components of national development strategies. Indeed, what distinguishes the US–LAC trade initiatives from many ventures between other developed and developing countries around the globe is the recognition by the developing countries that they need to adjust their domestic policies both to attract foreign investment and to promote competition in the home market. Without sustained economic reform – abetted by FTAs but primarily driven by domestic development imperatives – trade pacts will not generate the expected gains to trade and economic growth.

As mandated by the Summit leaders, the FTAA is a self-contained negotiation among the thirty-four democratic countries in the hemisphere. As a practical matter, however, these countries are already moving toward free trade at different speeds with different countries in the region. There are already numerous FTAs linking countries in North and South America, FTAs or customs unions among LAC neighbors, and a variety of "partial scope" trade accords that grant sector specific benefits to bilateral trading partners. Except for the NAFTA, most of these accords involve small volumes of trade: for example, intra-MERCOSUR exports in 2003 totaled only $12.7 billion or 12 percent of global exports of the four countries (down from 25 percent in 1999, and about the same percentage as when MERCOSUR was signed in 1991). By contrast, intra-NAFTA exports were valued at about $609 billion in 2003, and accounted for 57 percent of total exports of the three countries that year – and almost 80 percent of total trade between the Western Hemisphere countries (IDB, 2004).

The United States accounts for much of the hemispheric trade and large shares of the total trade of the Central American and Andean countries. Moreover, much of that trade is or will be liberalized under existing and prospective FTAs. The United States already has implemented FTAs with Canada, Chile, and Mexico, has ratified pacts with the five Central American countries and the Dominican Republic; and is currently negotiating FTAs with Colombia, Ecuador, Panama, and Peru. In addition, the Caribbean Basin Trade Partnership

Act of 2000 (CBTPA) extends US unilateral tariff preferences to most Caribbean exports not covered by the CBI through September 2008.[5] What is left not subject to free trade commitments is mainly US trade with MERCOSUR and with Venezuela.

Why, then, bother with an FTAA? The short answer is that an FTAA would yield both economic and foreign policy benefits. First, the FTAA would have beneficial effects on the conduct of overall economic policy in and economic relations among the participating countries. Second, the FTAA initiative covers the one big gap in the free trade matrix of the Western Hemisphere, linking the major economies of North and South America, whose bilateral trade – as projected by gravity models – could expand two- or three-fold in response to FTA-type reforms.[6] At the same time, the hemisphere-wide FTA would help harmonize over time the separate free trade regimes that have been negotiated among regional trading partners. Third, and perhaps most importantly, the FTAA is the economic engine that drives hemispheric cooperation on more than twenty initiatives undertaken by leaders at the Summit of the Americas involving a number of political, socio-economic, and cultural issues (e.g. promoting education, strengthening the rule of law, protecting the rights of indigenous peoples). Progress on the FTAA is critical to sustain efforts in these other areas.[7]

Many LAC countries already have open access to the US market for most merchandise products because of CBI and ATPA preferences, or because US MFN tariffs are zero or very low. Of course, there are a few notable exceptions, mostly involving agricultural goods; these products have been immune to deep MFN reforms and often are excluded from FTA or unilateral trade preferences. For many countries, the value of their bilateral FTAs and the FTAA is more secure access to the US market since these trade pacts turn their unilateral preferences into contractual obligations. By "locking in" open access to markets, free trade pacts help reduce uncertainty about the future course of trade and regulatory policies and thus facilitate business planning and investment. For many developing countries, this benefit is a key to the success of their investment-led development strategies.

For small economies, particularly those in the Caribbean, the stakes are even greater. For them, the issue is not whether to integrate with their hemispheric trading partners, but how to do so. Given their size, heavy reliance on the production and trade of a single commodity or service, underdeveloped physical infrastructure, and limited human and technological resources, these countries cannot afford to isolate themselves from their major markets since they are unlikely on their own to reap sufficient economies of scale and scope to compete effectively in global markets. The challenge for these countries is three-fold: encouraging growth in trade and inward investment from their FTAA partners; restructuring their economies to diversify the mix of production and expand employment opportunities; and managing the political backlash that inevitably will be provoked by the substantial adjustment burdens required to implement FTAA obligations.

FTAA: current status

Bluntly put, the FTAA negotiations have been stuck in the mud since the Miami Ministerial Conference of November 2003. At that time, soon after the failed WTO meeting in Cancun in September 2003 that had led to a breakdown in the Doha Round of multilateral trade negotiations, trade officials were under intense pressure "not to fail." Moreover, trade ministers did not want their leaders to have to address the ensuing mess when they convened in Monterrey, Mexico, two months later for a special Summit on Development. So the political imperative was to cut a deal in Miami and go home quickly. Accordingly, the Co-Chairs of the FTAA process – the United States and Brazil – produced a procedural compromise that allowed them to shake hands and promise to resume negotiating in early 2004. Despite infrequent bilateral meetings of ministers and chief negotiators, the US–Brazil rapprochement never advanced beyond a handshake to an *abrazo.*

The outcome of the Miami Ministerial Conference prevented the collapse of the trade negotiations but made it more difficult to achieve an agreement that balanced the interests of the participating countries. What went wrong?

At the Miami meeting, ministers "affirmed their commitment to a comprehensive and balanced FTAA" (paragraph 5), which includes "provisions in each of the [FTAA] negotiating areas" (paragraph 10). However, countries were permitted to take specific issues or products off the table, and some "countries may assume different levels of commitments" (paragraph 7). If other countries want to do more, say on investment, they could enter into so-called "plurilateral" agreements that only obligate those countries that sign the specific pact. In other words, the Miami compromise accommodated two levels of negotiation: a core FTAA in which countries could exclude sensitive issues, and supplementary accords by a subset of FTAA participants that covered "FTAA-plus" commitments.

The plurilateral option was introduced to accommodate the incremental development of an FTAA through a series of iterative negotiations. In so doing, however, it seemed to walk away from the comprehensive trade accord that hemispheric leaders promised at the Summit of the Americas in 1994, and had reiterated at their subsequent reunions in Santiago (1998) and Quebec City (2001). Some countries took the Miami mandate as license to try to remove entire areas from the talks – leading some observers to derisively label the potential outcome "FTAA-lite." The Brazilians certainly thought that they had pared down the negotiating agenda to core issues that need not include subjects sensitive to them – particularly, investment and intellectual property rights (IPRs) – but such a result is not viable, since the United States could not agree to liberalize its own border barriers to trade in the absence of reciprocal benefits for US traders and investors. If action on key trade and investment issues is deferred, will US or Brazilian officials be able to garner political support to reform long-standing barriers protecting farmers, manufacturers, and service providers?

In essence, the Miami Declaration presaged a "hollow core" agreement in which individual countries could avoid committing to reforms in politically sensitive areas (hence "FTAA-lite"). Thus, if Brazil and others did not want to negotiate on investment and IP issues, they could opt out of a hemispheric accord in those areas while the United States and others could adopt a more comprehensive accord among a subset of FTAA participants (probably the same countries that already have signed FTAs with the United States). The value of this plurilateral approach is unclear, since there is little "additionality" if the plurilateral pacts only involve existing US FTA partners.

At best, plurilateral pacts would seek to harmonize the terms of existing FTAs. However, such harmonization would require *inter alia* augmenting Canadian obligations in NAFTA and unraveling politically sensitive compromises on FTA origin rules for textiles, clothing, and agricultural products. Such a result is highly unlikely. While it is conceivable that a more limited outcome could balance US and LAC interests, the trade benefits resulting from such a modest undertaking would not seem sufficient to justify the political cost/risk of going back to Congress for another vote on these pacts. For Congress to approve changes in existing US trade barriers of interest to Brazil and other Latin American countries, US negotiators need to receive concrete commitments that open access to those markets for US exporters and investors. In short, the FTAA has to be a big deal, or the deal will not fly.

In sum, the Miami Declaration complicated the task of crafting a balanced package of concessions that negotiators can sell to their respective legislatures. It took pressure off the Brazilian negotiators by giving them an excuse for their minimalist position on so-called WTO-plus issues – i.e., those that go beyond the scope of existing WTO rights and obligations. For Brazil, the Miami decision seemed to condone a FTAA that simply removed traditional border barriers and did not require commitments on new issues like investment and competition policy. At the same time, it allowed US officials to defend inaction on US farm barriers because of lack of reciprocity from their Brazilian counterparts. In short, the talks have devolved into a caricature of the "Alphonse and Gaston" routine, with neither side willing (or possibly not politically able) to advance first.

Does the FTAA have a future?

Developments in two areas offer some hope that the FTAA can be revived and concluded (though perhaps not on the current timetable). First, recent progress on disciplines on agricultural subsidies in the Doha Round has reopened prospects for reviving the FTAA talks, which, like the WTO talks, have been stalled due to differences over agriculture. The WTO framework agreed on 1 August 2004 in Geneva includes a firm commitment to eliminate agricultural export subsidies and to substantially reduce domestic support and border barriers to trade in farm products. The WTO Ministerial Conference meeting in Hong Kong in December 2005 hopefully will clarify the scope and depth of cut of farm subsidies and border barriers in the Doha Round, and thus provide a clearer

political signal that many of the objectives of the hemispheric pact in this sector will likely be implemented on an MFN basis once the Doha Round accords are ratified. In that case, FTAA negotiators should be able to focus their efforts on market access problems involving specific products traded between Western Hemisphere countries.

Second, although the FTAA talks have drifted, concrete FTA negotiations have advanced among subsets of FTAA participants. This is not necessarily bad for FTAA prospects. If the bilateral and subregional accords accelerate the pace of economic reform, they will contribute importantly over time to the ability and willingness of Latin American and Caribbean countries to undertake the reciprocal obligations of the broader hemispheric pact. Indeed, US officials deliberately have moved forward with bilateral FTAs with a number of Latin American and Caribbean countries, challenging Brazil and its MERCOSUR partners to catch up when they are ready to proceed in the FTAA. Pacts with Chile, the CAFTA-5, the Dominican Republic, Panama, and the Andean-3 – along with deepening integration in the NAFTA region – are designed to maintain momentum and establish negotiating precedents for the broader FTAA exercise.

For its part, Brazil has adopted a similar trade strategy; it has signed skeletal FTAs with most of its LAC neighbors, and product-specific deals with Mexico and China; and it is negotiating a free trade pact with the European Union (whose progress lags as well). To date, the Brazilian strategy has scored political points in Latin America but made little progress in advancing Brazilian export interests in the major industrial markets.

Interestingly, the countries with the greatest interest in an FTAA today are the small, trade-dependent Caribbean countries that could suffer significant trade and investment diversion if their trade preferences in the US market are not transformed into permanent FTAA obligations. As noted earlier, key US tariff preferences under the CBTPA expire in September 2008; uncertainty over whether these preferences will be upgraded in a free trade pact or, worse yet, not extended will increasingly cast a cloud over development plans among the Caricom countries. These small economies stand to be the biggest losers if US–Brazil differences continue to stall the FTAA negotiating process.

The United States and Brazil will continue to Co-Chair the FTAA talks for their duration. However, a deal will not get done unless the leading economies of North and South America can bridge their differences and offer concrete new opportunities for their exporters and investors in each other's markets. If they succeed, then the FTAA will become a reality. If not, then the United States will continue to pursue FTAs with groups of LAC countries, which will effectively discriminate against the MERCOSUR-4. In that event, the FTAA negotiations will either continue to drift or devolve into an Asian-style "FTAA-lite." Either way, US trade policy will focus elsewhere.

The basic problem is two-fold: whether Brazil will open its market to foreign competition in goods and services, and whether the United States will reciprocate by increasing market access for Brazilian agriculture and competitive manufactures. In both cases, prospective liberalization is contentious and subject to a

fractious domestic debate. In both cases, electoral and legislative considerations probably will constrain negotiations through much of 2006, if not longer.

In Brazil, recent political scandals have weakened President Lula da Silva and cast doubts on his re-election. Under these circumstances, the PT regime seems unlikely to risk further dissension within its own ranks by considering controversial policy reforms. Until the October 2006 election, Brazilian negotiators may thus resist negotiating over reforms of important regulatory barriers (including those for the services industries), strengthening protection of IPRs, and opening of some public procurement tenders to bidding by foreign suppliers. Such reforms are supported by some parts of the Brazilian business community, but staunchly opposed by protectionist interests.

A FTAA deal could provide large inducements to undertake such reforms, but only if the United States commits in turn to providing concrete new trading opportunities in the US market for Brazilian farmers and industrialists – especially by slashing subsidies and committing to liberalization in politically sensitive areas such as cotton, sugar, tobacco, and citrus. In his speech to the United Nations in September 2005, President Bush pledged that "the United States is ready to eliminate all tariffs, subsidies and other barriers to free flow of goods and services *as other nations do the same*" [emphasis added].[8] Loosely translated, this means that he will ask Congress to authorize trade and subsidy reforms commensurate with liberalization undertaken by the European Union and other major trading nations in the Doha Round. The success of this negotiating gambit will turn, however, on what Congress legislates in the new US farm bill that will be drafted in 2006.

Unfortunately, support for the FTAA within the United States has ebbed. At present, Congress is distracted by the war on terror, Iraq, hurricane relief, and Supreme Court nominees, and members repel the thought of another trade vote akin to CAFTA anytime soon. Indeed, the hangover from the CAFTA debate (which passed the House of Representatives by a two-vote margin after extensive and expensive lobbying efforts by the administration) may be long-lasting on both ends of Pennsylvania Avenue.

Support for the FTAA from the US business community is more positive, especially among South Florida businessmen hoping to attract the headquarters of the FTAA secretariat, but not particularly active. US companies have focused their efforts on the Doha Round and on specific bilateral FTAs, where they expect a more immediate payoff (albeit small) than from the FTAA. US exports to and investment in the LAC region have lagged in recent years, further dampening enthusiasm. Since 2000, US shipments to the LAC region (including Mexico) have increased even more slowly than the sluggish 1.4 percent annual average growth for total US exports, and those to the MERCOSUR-4 have declined significantly. While US FDI in the LAC region is reviving after dropping sharply earlier this decade, US outflows of equity capital have virtually dried up; most of the new US FDI is reinvested earnings of existing US subsidiaries. To be blunt, US business seems to be giving higher priority to other regions that offer greater prospects for trade and investment opportunities.

The Summit of the Americas to be held in Mar del Plata, Argentina, in

November 2005 may provide an opportunity to break the current impasse. Political leaders need to reiterate their objective of achieving free trade in the hemisphere as part of the broader efforts to promote economic development and reduce poverty in the region. All FTAA participants except Venezuela have done so in past summits and should recommit to finish talks soon after the conclusion of the Doha Round. President Bush recently voiced his determination to follow through with the Summit of the Americas commitment at the NAFTA leaders meeting in Crawford, Texas in March 2005; President Lula da Silva and other Latin American leaders should do so as well.

In particular, the Mar del Plata Summit Declaration should provide a strong political mandate to restart the trade talks and direct the FTAA Co-Chairs to immediately consult with the other FTAA participants. The long-delayed FTAA Ministerial Conference to be hosted by Brazil should be convened in 2006 to revive talks in all the negotiating groups, including agriculture. Trade ministers could then update the Miami mandate to reflect recent events, including the progress on agriculture and other issues in the Doha Round of WTO negotiations. One would then expect the FTAA talks to build on the results of the Doha Round – which means that concluding the FTAA will require the reauthorization of US trade promotion authority in June 2007 (which, in any event, is necessary for the conduct of overall US trade policy).

Notes

1 For an insider's account of the evolution of the 1994 Summit of the Americas, see Feinberg (1997).
2 For a comparative analysis of the APEC and Western Hemisphere trade initiatives, see Feinberg (2000).
3 The groups cover: market access for non-agricultural goods; agriculture; services; intellectual property rights; subsidies and antidumping/countervailing duties; government procurement; investment; competition policy; and dispute settlement.
4 Post-war European integration has both political and economic dimensions. Countries have been willing to cede sovereignty to supra-regional authorities as part of the process of creating a more politically unified Europe. Part of the glue of the alliance was transfers mandated by the common agricultural policy. In addition, new entrants received regional aids to assist in the adjustment to the common European regime. This is obviously only a caricature of the process of European integration. However, it suffices to make the simple point that the European experience has had much broader economic and political goals than those sought in the FTAA.
5 The CBTPA provides "NAFTA parity" for products (mostly textiles and apparel) excluded from the Caribbean Basin Economic Recovery Expansion Act of 1990, known as CBI II. Unlike the CBI preferences that have no termination date, the supplementary benefits under CBTPA must comply with NAFTA rules of origin and expire on 30 September 2008.
6 Bilateral trade between the United States and Brazil is relatively small; two-way trade was $35 billion in 2004 – by contrast, US–Mexico trade was valued at $266 billion. The FTAA would provide the first major trade accord between the United States and Brazil and its MERCOSUR partners.
7 For more detailed discussion of FTAA benefits, see Schott (2001).
8 For the extract of Bush's speech, with supporting factual detail, see USTR (2005).

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12 Competing for the US import market

NAFTA and non-NAFTA countries

Jorge Chami Batista

Introduction

The experience of Mexico as a member of NAFTA is of fundamental importance for other Latin American countries engaged in the FTAA negotiations. However, the results of free trade agreements (FTAs) are hard to appraise. As far as FTAs are concerned, very often the past seems to be almost as uncertain as the future. We have no means of finding out what would have happened to the economy of Mexico without NAFTA.

Sometimes, free trade agreements are sold as an easy route for development. As a result, anything short of that would be regarded as a complete failure. But a free trade agreement with a rich country does not automatically lead to income convergence for the poor country. In other words, free trade agreements are no panacea, and ought not to be blamed for all the difficulties developing countries have to confront in order to raise their relative per capita income levels. Many of these difficulties depend on institutional reforms and the implementation of good policies. FTAs can help, but merely as a set of rules. They cannot be a permanent solution for all the problems ahead.

No attempt will be made here to appraise the welfare effects of NAFTA on Mexico. The objective here is to analyze the changes in the composition of US imports by product and country of origin and the possible effect of NAFTA on these changes. Has it helped Mexico to attract foreign direct investment and raised Mexico's shares in imports of the US and other markets? What happened to non-NAFTA countries' and Canada's shares of US imports as a result of NAFTA? What has been its effect on Brazil's exports to the US? Has it been negligible as anticipated before the actual implementation of NAFTA? These are some of the questions addressed in this chapter.

The CMS model and the method of attributing a country's gains and losses of competitiveness to competitors

In order to address these questions I shall apply the well-known method of constant-market-shares analysis to the US import market, comparing imports by country of origin in 2004 with the same import data in 1992 and 1999. I shall

also apply a new extension to this method designed to identify for each exporting country the competing countries from which they gained market shares and those to which they lost market shares in these periods.

The constant-market-shares (CMS) model is based on an identity between the change in the market share of a particular exporting country **H** in a given market **K**[1] from the initial year **t** to the final year **t + 1** and the so-called product composition and competitiveness effects.[2] The product composition effect calculates to what extent the macro share gain (or loss) of country **H** can be attributed to the concentration of its exports in goods for which import spending is growing more rapidly (or slowly) in relative terms. The competitiveness effect calculates to what extent the macro share gain or loss of country **H** can be attributed to the sum of gains and losses of market shares on individual products.[3]

Assuming that there are **n** countries exporting any particular good imported by market **K**, the change in the market share of a country H ($\Delta \mathbf{k}_H$) between period **t** and **t + 1** may be said to be identical to the sum of the net gains or losses of country **H** to all its competitors **J**,

$$\left(\sum_{J \neq H}^{n} \Delta \mathbf{k}_{H,J} \right).$$

In other words, any gain or loss of market share of a particular country must be accounted by its competitors. It is then possible to show that this change is identical to the sum of the difference between the rates of growth of exports of country **H** ($\hat{\mathbf{x}}_H$) and all competing countries **J** ($\hat{\mathbf{X}}_j$), divided by 1 plus the rate of growth of the market **K** ($\mathbf{1} + \hat{\mathbf{m}}$), and multiplied by the initial market shares of country **H** ($\mathbf{k}_H$) and countries **J** ($\mathbf{k}_J$) in market **K**:[4]

$$\Delta \mathbf{k}_H \equiv \sum_{J \neq H}^{n} \Delta \mathbf{k}_{H,J} \equiv \sum_{J \neq H}^{n} \left[\frac{(\hat{\mathbf{x}}_H - \hat{\mathbf{x}}_J)}{\mathbf{1} + \hat{\mathbf{m}}} \cdot \mathbf{k}_H \cdot \mathbf{k}_J \right] \tag{12.1}$$

If it is then assumed that:

$$\Delta \mathbf{k}_{H,J} = \frac{(\hat{\mathbf{x}}_H - \hat{\mathbf{x}}_J)}{\mathbf{1} + \hat{\mathbf{m}}} \cdot \mathbf{k}_H \cdot \mathbf{k}_J \tag{12.2}$$

it is easy to show that the change in the market share of exporter **H** attributed to any exporter **J** ($\Delta k_{H,J}$) fulfills four desirable properties. First, competitor **H** cannot gain from or lose to itself ($\Delta k_{H,H} = 0$). Second, the gain of exporter **H** from exporter **J** is equal to the loss of exporter **J** to exporter **H** ($\Delta k_{H,J} = \Delta k_{J,H}$). Third, the sum of the gains and losses of any supplier to all its competitors would be equal to the total gain or loss of that supplier in the period, as established in identity (12.1). And fourth and perhaps the most important property, the change in the market share of exporter **H** attributed to any exporter **J** ($\Delta k_{H,J}$), ought to have the same sign and be a function of the difference between the rates of growth of exports by exporters **H** and **J** ($\hat{\mathbf{x}}_H - \hat{\mathbf{x}}_J$).

Main gainers and losers of competitiveness in the US import market

Examining the macro (aggregated) shares in US imports of the main exporting countries in the period from 1989 to 2004, it is easy to see that Mexico's share rose after 1989, accelerated between 1993 and 1996 following the implementation of NAFTA and the depreciation of the peso, and declined after 2002. China's share grew fast until 1993, decelerated after that, but showed a spectacular increase after 2001, probably reflecting her accession to WTO membership. The fall in Japan's share was also impressive, especially between 1993 and 1996. The decline in Canada's share was smooth and took place after 1996.[5]

Mexico's exports also tended to rise as a share of imports of goods in Canada and Chile. In both cases, Mexico appears to have benefited from the FTAs with these countries.[6] However, it is interesting to observe that the performance of Mexico's exports in other import markets was not as good as in the North American and Chilean markets. The rise in the very small market share of Mexico in the European Union (EU-15) after 1998 follows the start of the FTA between these countries, but it was short-lived, returning in 2004 to the same levels as in 1998, 1996 and 1994. In Argentina, Brazil, China and Japan, the shares of Mexico's exports fluctuated in the period, showing no clear trend.[7]

Therefore, the continuous rise in the US market share of Mexico from 1992 to 2002 appears to be related to NAFTA, since the performance of Mexico's exports was relatively modest in the same period in markets where it did not benefit from FTAs. In contrast, China tended to gain market shares in all these markets.[8]

Applying the constant market share model to US imports by product in the period 1992–2004,[9] Table 12.1 shows the competitiveness effects by exporting countries. China is by far the largest gainer of competitiveness, with almost half of the total gains. Mexico comes second, with export revenues in 2004 near $50 billion in excess of what would have been necessary to maintain constant its 1992 shares of all products in US imports. On the other hand, Japan is the main loser of competitiveness in the period, followed by Taiwan and Canada. It should be noted that the loss of Japan is of the same order of magnitude as the gain of China, both over the extraordinary mark of $100 billion. The loss of

Table 12.1 Main gainers and losers of competitiveness in the US market, 1992–2004 ($billion)

Gainers	*Gains*	*%*	*Losers*	*Losses*	*%*
China	134.0	46	Japan	–112.6	38
Mexico	48.9	17	Taiwan	–36.0	12
Ireland	17.1	6	Canada	–27.5	9
Russia	9.4	3	U.K.	–20.9	7
Others	83.4	28	Others	–95.8	33
Total	292.9	100	TOTAL	292.9	100

Table 12.2 Main gainers and losers of competitiveness in the US market, 1999–2004 ($billion)

Gainers	*Gains*	*%*	*Losers*	*Losses*	*%*
China	91.7	59	Japan	–35.6	23
Ireland	8.9	6	Canada	–32.3	21
Nigeria	5.8	4	Taiwan	–13.3	9
Brazil	5.2	3	U.K.	–12.5	8
Vietnam	4.4	3	Mexico	–8.6	6
Others	38.5	25	Others	–52.3	34
Total	154.5	100	Total	–154.5	100

Canada in the period may seem surprising in view of NAFTA's implementation. But, in fact, previous agreements had already given Canada almost free access to the US import market,[10] and Mexico turned out to be a fierce competitor for Canada in the US market after NAFTA.

Table 12.2 reveals the competitiveness effects for the subperiod 1999–2004. China accounted for almost 60 percent of the total gains in this subperiod, showing that 68 percent of China's gains between 1992 and 2004 took place in the latter five years.[11] Mexico, on the other hand, lost competitiveness in the period, revealing that its gain between 1992 and 2004 took place entirely in the period 1992–1999. Canada became the second main loser of competitiveness right after Japan in the subperiod 1999–2004. By noting the differences between the two periods, it is possible to infer that Canada gained competitiveness in the subperiod between 1992 and 1999. Ireland was the second main gainer in 1999–2004, followed by three exporters with large shares of resource-based products in their total export revenues: Nigeria, Brazil and Vietnam.

Attributing the gains and losses of China to her competitors in the US import market

Let us now apply the method of attributing a country's gains and losses of competitiveness to competitors. Table 12.3 shows the gains and losses of China by the main competing countries in the period 1992–2004. In this period, most of China's gains came from the main overall losers: Japan, Taiwan and Canada. Together, they accounted for half of China's gains. Note that, despite NAFTA, China gained from Mexico. China also gained from the other more industrialized countries of Asia: the Republic of Korea, Singapore, Malaysia, Hong Kong and others.

In point of fact, China's loss was very small in the period, only $3 billion, and none of the exporters that gained from China is a developed country. Almost all of them are poor countries, and they gained from China in natural resource-based products (petroleum and its derivatives; and shrimps) and textiles (clothing and footwear), often made of cotton. China lost competitiveness in only 327 out of 3,015 products[12] exported to the United States in the period. Although this

Table 12.3 China's gains and losses by competitors in the US, 1992–2004

Gross gain ($billion)	*137.2*	*%*	*Gross loss ($billion)*	*–3.2*	*%*
Japan		24	Vietnam		24
Taiwan		18	Pakistan		7
Canada		8	Cambodia		7
Korea		7	Nigeria		5
Mexico		6	Saudi Arabia		5
Singapore		5	Honduras		5
Germany		4	El Salvador		4
Malaysia		3	India		4
Hong Kong		3	Russia		4
Net gain ($billion)	134.0				

loss still is very small, it is possible to see that resource-rich and low-wage countries are beginning to gain from China in resource-based low-wage products. This is because Chinese wages are bound to rise and the exchange rate to appreciate as a result of China's development. China's losses to Vietnam were concentrated in the subperiod 1999–2004 (98 percent), and in articles of apparel and clothing accessories (56 percent) and footwear (22 percent).

China's major gains from Japan and other Asian countries in 1992–2004 were concentrated in products of the computer industry (Japan, Singapore, Taiwan and Korea), some consumer electronics such as video recording equipment (Japan and Korea) and video games (Japan), transmission apparatus or cellular phones (Japan and Singapore), and leather footwear (Korea and Taiwan). China's gains from these countries were more or less split in the subperiods 1992–1999 and 1999–2004.

China's main gains from Mexico in the same period came largely from the telecom industry (TV sets, parts and accessories), from the computer industry (digital processing units, components and parts), from the electrical industry (insulated electric conductors and static converters), and from metal finished products (domestic cooking appliances). The gains of Mexico from China were relatively small, totaling $1.4 billion against losses of $9.8 billion, and were mainly in natural resources (petroleum and shrimps), articles of apparel and clothing accessories, cellular phones, and electrical machines and apparatus.

China's gains from Mexico were larger in the period 1999–2004 than in 1992–2004, especially in electronics,[13] implying that Mexico actually gained from China in 1992–1999 on the basis of the 2004 US import structure.[14] Note that Mexico is the sole exception: no other country among the top fifteen losers to China in 1992–2004 gained from China in 1992–1999. Canada lost to China in 1992–2004, particularly in computer products (SITC 75997 and 75230), auto parts (SITC 78439), and furniture (SITC 821) and 92 percent of these losses were concentrated in the period 1999–2004.

Attributing the gains and losses of Japan to her competitors in the US import market

Table 12.4 shows that Japan lost to the main gainers: China and Mexico. In fact, Japan lost to all the gainers and to all of the big losers of competitiveness in the US market except Hong Kong. Note, however, that Japan's total gross gain was negligible.

Japan's main losses to China have already been analyzed and found to be largely concentrated in the electronics industries. The losses to Mexico were mainly in the automotive industry (29 percent), electrical equipment (17 percent), telecom products (13 percent) and computers (10 percent).[15] The losses to Canada were heavily concentrated in products of the automotive industry.[16] Two products accounted for 62 percent of the gains of Korea from Japan: automobiles (40 percent) and cellular phones (22 percent). Automobiles also accounted for 61 percent of Germany's gains from Japan, while 57 percent of the gains of Malaysia from Japan were in products of the computer industry. Ireland obtained 78 percent of her gains from Japan in products of the chemical industry. To Taiwan, the main losses of Japan were in unrecorded media (17 percent), integrated units (18 percent), computers and parts (14 percent), TV sets (2 percent) and video recording apparatus (2 percent).

Attributing the gains and losses of Mexico to her competitors in the US import market

Mexico also gained, mostly from the large overall losers in the US import market in 1992–2004, though Canada and some European countries had a much larger weight in Mexico's gains than in the overall losses shown in Table 12.1. It should be noted in Table 12.5 that China accounted for 70 percent of Mexico's relatively small losses in the period.[17] Almost all the other countries to which Mexico lost in this period were exporters of some specific resource-based

Table 12.4 Japan's gains and losses, 1992–2004

Gross loss ($billion)		*–113.2*
China	29%	
Mexico	15%	
Canada	12%	
Korea	9%	
Germany	8%	
Malaysia	4%	
Ireland	4%	
Taiwan	3%	
Gross gain ($billion)		*0.5*
Hong Kong	76%	
Net loss ($billion)		–112.6

Table 12.5 Mexico's gains and losses, 1992–2004

Gross gain ($billion)		*60.9*
Japan	28%	
Canada	23%	
Taiwan	7%	
UK	5%	
Germany	5%	
Gross loss ($billion)		–12.0
China	70%	
Net gain ($billion)		48.9

products, such as petroleum and derivatives from Iraq, Algeria and Russia, but these losses totaled just $4 billion.

Mexico's gains from Japan had already been analyzed. Canada's losses to Mexico were heavily concentrated in products of the automotive industry, which accounted for 57 percent of Canada's total losses to Mexico: trucks (37 percent); passenger cars (6 percent); road tractors for semi-trailers (6 percent); parts (6 percent); and others (2 percent). This does not include the losses in internal combustion piston engines which accounted for another 4 percent of Canada's losses to Mexico.

Mexico's gains from Taiwan include computers (21 percent), transmission apparatus and cellular phones (9 percent), lighting fixtures (6 percent), padlocks and locks of metal (7 percent), ignition wiring sets used in vehicles and other electric conductors (16 percent), and articles of apparel and clothing accessories (10 percent).[18]

Mexico's gains from the UK were mainly in crude petroleum (SITC 33300) and computers (75230), while from Germany they were mainly in engines for vehicles and their parts (SITC 713); pumps for engines (74220); other pumps (74319); some metals (67, 68, 69), electrical products (77); instruments and appliances for medical purposes (87229 and 87221); and other professional, scientific and controlling instruments (87).

Mexico's gains from Brazil

Mexico's competitiveness gain from Brazil amounted to $686 million in the period 1992–2004. Although this represented only 1.1 percent of Mexico's gross gains, it represented 15 percent of Brazil's gross losses of $4.6 billion in the period. In point of fact, Brazil was a net gainer of competitiveness in the period, but lost first to China, which accounted for 37 percent of Brazil's gross losses, and second to Mexico.

Considering Brazil's gains and losses by competing countries in the subperiod 1999–2004, it is possible to see that Brazil gained from Mexico in this period, which implies that Brazil's losses to Mexico in 1992–2004 were entirely concentrated in the period between 1992 and 1999. NAFTA was implemented

during this last subperiod, but this was also the subperiod in which the Brazilian currency suffered a major appreciation against the Mexican currency. Furthermore, the second subperiod coincides with a strong depreciation of the Brazilian currency against the Mexican currency. Therefore, the effects of NAFTA and exchange rate changes on Mexico's gains and losses to Brazil need to be disentangled.

Examining Brazil's gross losses to Mexico by product in the period 1992–2004, it turns out that 29 percent of these losses occurred in the steel industry and 23 percent in the automotive industry, including engines, vehicles and parts. More interestingly, out of a total gross loss of $1.27 billion to Mexico, 10 percent were in a group of products for which Brazil gained competitiveness overall[19] in the period; 37 percent were in a group of products for which Mexico accounted for at least 75 percent of Brazil's losses; and 34 percent were in a group of products for which Mexico accounted for between 10 percent and less than 75 percent of Brazil's losses. Altogether, these products accounted for $1.04 billion, 81 percent of Brazil's gross loss in the period, or 4.7 percent of Brazil's exports to the US in 2004. Just the first two groups of products accounted for $600 million, 47 percent of Brazil's gross loss, or 2.8 percent of Brazil's exports to the US in 2004.

Brazil paid import tariffs in 1994 and 2004 for the products which accounted for at least 98 percent of the losses made in the products of the first group, 96 percent of the second group and 78 percent of the third group. It should be borne in mind that the existence of a margin of preference to Mexico does not necessarily imply that Brazil's losses were entirely due to NAFTA. On the other hand, NAFTA may have played a part even in products for which imports are tariff-free in the US, due to economies of scope, economies of scale and externalities generated by NAFTA regarding the production and transportation to the US of all goods from Mexico.

Furthermore, it can be argued that even in products where Brazil gained market share from Mexico, NAFTA may have reduced these gains. Therefore, one could rather conservatively estimate the negative effect of Mexico's participation in NAFTA on Brazil as something between 2.8 percent and 4.7 percent of Brazil's exports to the US, compared to an expectation, before the implementation of NAFTA, of less than 1 percent of Brazil's exports to the US.[20]

In order to explore why China and Mexico gained while Japan lost competitiveness in the US import market in 1992–2004, it will be interesting to examine the role played in these trade gains and losses by multinational companies, especially Japanese and North American companies, considering their location decisions. It is well known that US imports of the automotive and electronics industries are to a large extent related party trade.[21] In point of fact, related party trade accounted for 93.4 percent of US imports of motor vehicles, 70.2 percent of computers, 72.5 percent of communications equipment and 66.2 percent of chemicals in 2004.[22] Related party trade also accounted for 61 percent of US imports from Mexico, 79 percent of US imports from Japan, but only 27 percent of imports from China, compared with an average of 48 percent of total US imports in 2004.[23]

Therefore, the analysis of foreign direct investment into the US and of US foreign direct investment abroad as well as US imports from US affiliates abroad may shed some light on the factors behind the gains and losses of some exporting countries to the US import market. In the next sections, an attempt is made to relate the operations of Japanese and US multinationals to the gains and losses of exporters in the US import market, especially in the automotive and electronics industries.

Relocation of the automotive and electronics industry

It emerges clearly from the previous analysis that most of the gains and losses of the main exporters to the US are concentrated in the automotive and electronics industries. Japan is always the main loser as an exporter to the US of products of these two industries. In the automotive industry, Japan lost mainly to Mexico, Korea, Germany and Canada, but Canada also lost to Mexico. In computers, Japan lost mainly to China, Mexico, Korea, Taiwan and Malaysia; China gained from Canada, Mexico and Taiwan; and Mexico gained from Korea and Taiwan. In the telecom industry, Japan lost mainly to Korea and Malaysia, Canada lost to Korea, and Mexico to China. Finally, in consumer electronics, Japan lost mainly to China, Taiwan and Malaysia, and Mexico lost to China.

These changes in market shares of the main exporters to the US reflect a major relocation of these industries in the world. In particular, Japanese FDI abroad appears to be especially relevant to explaining the losses of Japan's exports in the US market. Indeed, although the share of Japan in US imports of automotive and electronic products decreased drastically in the period, Japanese companies seem to have maintained their position in the market through massive foreign investments in these industries abroad. US FDI in Mexico has also been very important for Mexico's exports back to the United States. China's exports, on the other hand, benefit from FDI from Hong Kong, Taiwan, as well as from the US and Japan, among others.

Japanese direct investments in affiliates abroad

Japanese cumulative outward foreign direct investments totaled $733 billion[24] in the period from 1989 to 2004, of which $264 billion (36 percent) went into manufacturing industry abroad. The electrical and electronics industry accounted for 29 percent of the outward direct investments in manufacturing industry from Japan in the period, while the transportation equipment industry accounted for 17 percent.[25] Therefore, these two industries accounted for little less than half of Japanese outward direct investments in manufacturing industry in the period. These were the two most important manufacturing industries in which Japan has invested abroad. The result has been a phenomenal relocation of Japanese industrial production capacity.

A large part of these outflows of Japanese investment went to North America, especially in the period 1989–1998, as Table 12.6 shows. In the past five years,

Table 12.6 Outward foreign direct investment from Japan (in percent based on Japanese yen)

Regions and countries	*Total*			*Manufacturing industry*		
	1989–2004	*1989–1998*	*1999–2004*	*1989–2004*	*1989–1998*	*1999–2004*
North America	37.9	43.8	26.3	40.1	43.3	35.7
USA	36.4	42.1	25.1	37.5	40.6	33.3
Canada	1.5	1.7	1.2	2.6	2.7	2.4
Latin America	11.2	9.4	14.9	4.5	3.8	5.5
Brazil	1.4	1.3	1.8	2.0	1.7	2.3
Mexico	0.5	0.4	0.9	1.3	1.0	1.8
Asia	17.3	17.9	16.1	27.7	30.5	23.7
China	3.8	3.2	4.9	8.1	7.5	9.0
Europe	27.8	21.8	39.6	24.7	18.4	33.6
Other	5.8	7.1	3.0	3.0	4.0	1.6
Regions and countries	*Transportation industry*			*Electrical and electronics*		
	1989–2004	*1989–1998*	*1999–2004*	*1989–2004*	*1989–1998*	*1999–2004*
North America	25.8	40.4	12.5	54.4	48.9	61.5
USA	23.6	36.1	12.3	53.6	47.6	61.5
Canada	2.2	4.3	0.2	0.7	1.3	0.0
Latin America	9.2	8.9	9.5	2.5	2.2	2.9
Brazil	2.1	2.6	1.7	1.5	0.6	2.6
Mexico	6.2	5.3	7.0	0.1	0.1	0.0
Asia	24.9	23.0	26.6	24.2	28.2	19.0
China	9.1	5.4	12.6	6.6	6.9	6.3
Europe	36.1	21.9	49.0	18.6	20.3	16.3
Other	4.0	5.8	2.4	0.3	0.3	0.4

Source: Ministry of Finance of Japan, www.mof.go.jp/english/e1c008.htm. Access in November 2005.

from 1999 to 2004, Japanese multinationals made an interesting move, relocating their foreign investments towards Europe and Latin America.[26] This was particularly true for Japanese investments in the transportation equipment industry in Europe, which accounted for almost half of all Japanese FDI in this industry in this subperiod.[27] China has also received a large and increasing proportion of Japan's investment, especially in manufacturing and, more specifically, in the transportation equipment industry. This might represent a big threat for exporters of products from the automotive industry in the future, since Chinese auto assemblers have so far focused on the domestic market. Chinese exports of auto parts, nevertheless, have already been gaining market share in the US import market.[28]

As is well known, investments of Japanese car makers in the US began in the early 1980s, in response to US threats of a trade war. The share of Japanese imported cars in the US car market had increased from 12 percent in 1978 to 20 percent right after the second oil shock, widening the US trade deficit with Japan. The Japanese Government compromised, agreeing with "voluntary" export restraints (VERs).[29] Honda started its transplant production in the US in 1982, Nissan in 1983 and Toyota (New United Motor Manufacturing Inc., NUMMI) in 1984.[30] The appreciation of the Japanese yen after the Plaza agreement in 1985 gave a further incentive to Japanese foreign direct investments abroad.

As a result of these investments, Japanese automakers increased their production in the US from 0.6 million vehicles in 1986 to 1.7 million in 1992, whereas Japanese exports of vehicles to the US fell from 3.4 million units to 1.8 in the same period. However, this process deepened after 1992, and in 2004 Japanese exports were down to 1.6 million units, while Japanese production in the US reached 3.2 million units. Japanese affiliates in the US also produced 3.2 million engines in 2004.[31] Therefore, although this relocation did not start with NAFTA, it continued under NAFTA.

Locally built vehicles accounted for 67 percent of the total supply of Japanese cars and trucks in the US market in 2004 compared with 48.6 percent in 1992 and 12 percent in 1986. Import penetration from Japan in the US retail market of passenger cars fell from 20.1 percent in 1985 to 17.7 percent in 1992 and 8.8 percent in 1997.[32] However, the retail market share of passenger cars from all Japanese manufacturers[33] increased from 20.1 percent in 1985 to 30.1 percent in 1992 and 31 percent in 1997.[34] Daimler AG purchased Chrysler Corporation in 1998, but the market share of the "Big three" (GM, Ford, and DCX) fell from 73.7 percent in 1993 to 59.2 percent in 2003.[35] On the other hand, Japanese manufacturers of cars and trucks increased their share of the US market from 19.3 percent in 1985 to 24 percent in 1992 and 28.2 percent in 2003.[36]

According to a Japanese annual survey,[37] sales to the US transportation equipment market of a sample of Japanese affiliates located in the US rose from $20 billion in 1992 to $70 billion in 2001, an increase of $50 billion in the period. However, sales of Japanese affiliates from China and Europe to the US transportation equipment market increased only $260 million and $8 million in

the same period, respectively, while sales from other Asian countries actually declined $1.48 billion in the same period.

According to another survey of Japanese affiliates in the US,[38] the number of Japanese plants in transportation equipment and parts rose from 311 in 1997 to 398 in 2002. Procurement of US-made raw materials and parts was quite high, with over half of the plants reporting local content ratio of over 70 percent and two-thirds of the plants reporting a ratio of over 50 percent. Japan is the main import source of materials and parts, at 85 percent. However, local content and imports from Japan are declining and are expected to continue to decline as Japanese plants in the US are changing their procurement sources to China, especially in electrical/electronic parts, and to Mexico, especially in auto parts. Competition from Chinese imported products was strongly felt by Japanese plants in the US in the textile,[39] electrical and electronic-related industries, but had limited impact on transportation equipment related industries.

Japanese outward foreign direct investments in the electrical and electronics industry were heavily concentrated in the US economy, according to the evidence presented in Table 12.6. Brazil, Korea and Taiwan also increased their share of Japanese foreign investments in this period, but Mexico, Canada, Europe and the rest of Asia, including China, saw a decrease in their shares. It appears that, except for Brazil, Japanese foreign investments in this industry were channeled to countries with skilled labor, specialized knowledge and R&D infra-structure. In Brazil, these investments seem to be largely related to new assembly plants for the production of cellular phones, whose exports to the US experienced a recent boom.

Sales of electrical and electronic products of a sample of Japanese affiliates in the US to the local market increased from $20.3 billion in 1992 to $46.1 billion in 2001, whereas in the same period exports of Japan to the US of these products fell from $33.1 billion to $31.6 billion. Sales of these products of Japanese affiliates from China, from other Asian countries and from Europe to the US market increased $1.63 billion, $4.27 billion and $33 million in the same period, respectively.[40] Exports of this sample of Japanese affiliates in China to the US in 2001 were equivalent to just 5.5 percent of China's total exports of electrical and electronic products.

According to a government report[41] "…Japanese companies saw their global market shrink as the electronics industry continued shifting its production operations overseas…" But "to acquire a high share of world markets, production in China and other Asian countries is essential". However,

> Japanese companies have also begun rebuilding their development and production systems within Japan, through management reforms, development of new products, improvement of high-mix low-volume production methods, reduction of product development and delivery times and costs, and increased domestic production of semiconductors. As a result, manufacturers of digital consumer electronic products such as flat screen TVs and digital cameras have succeeded in capturing large global market shares by

> bringing to market new products that were first experimentally manufactured and then mass produced in Japan.

The ratio of domestic production to world production of Japanese manufacturers and the world share of Japanese manufacturers of some consumer electronic novelties, such as car navigation systems (100 percent, 99.7 percent), plasma display panels – PDPs (99.1 percent), video tape recorder – VTR cameras (87.2 percent, 84.6 percent), liquid crystal displays – LCD TVs (81.5 percent), compact/small and medium color liquid crystal parts (78.1 percent), DVD recorders (65.4 percent) and digital cameras (81.2 percent, 57.7 percent), were both over 50 percent in 2003.[42] In point of fact, Japanese companies in the electronics sector, despite the fall in the share of Japanese exports in this sector, remain at the top of the 2002/03 world rank, occupying five of the top ten places in electronics revenues and ten of the top thirty.[43]

Note that Japanese total and manufacturing industry FDI in Mexico was smaller than in Brazil in both subperiods of Table 12.6, except for the transportation equipment industry, in which Japanese FDI was almost three times higher in Mexico than in Brazil, increasing in the most recent subperiod. NAFTA has definitely played an important role here, attracting Japanese investment for the Mexican automotive industry and thus helping to raise exports to the US market. More recently, the agreement between Mexico and the EU and the prospect of an agreement between Mexico and Japan may have helped to raise Japanese investments in Mexico.

US imports of goods shipped by US affiliates from abroad

US imports of goods shipped by US affiliates from abroad reflect the development of export capacity resulting from foreign direct investments of US multinationals abroad. NAFTA countries have accounted for a dominant share of imports from affiliates of US companies abroad, as shown in Table 12.7.[44] This table also reveals that Mexico has benefited the most from the relocation of manufacturing export capacity of US affiliates since the late 1980s and early 1990s. Indeed, the share of Mexico in US imports of goods shipped from all US affiliates in manufacturing industry abroad increased from 9.0 percent in 1989/1990 to 22.7 percent in 2002/2003. Other countries, such as Ireland, Malaysia, Singapore[45] and China, have also benefited significantly from the relocation of export capacity of US affiliates abroad in this period. On the other hand, the shares of the largest economies of Europe, Canada[46] and Japan, in particular, fell drastically in the same period. The shares of Hong Kong[47] and Brazil also declined sharply in the period.

The large relative increase in US imports from US affiliates in Mexico provides evidence that NAFTA helped Mexico to attract export capacity from US affiliates abroad that could otherwise have gone to other countries.[48] On the other hand, export capacity of US affiliates abroad has moved away from Brazil, the principal Latin American competitor of Mexico as a recipient of foreign

Table 12.7 Shares of US imports of goods shipped by US affiliates by regions and countries (percent)

	All industries		*Manufacturing industries*	
Regions and countries	*1989/1990*	*2002/2003*	*1989/1990*	*2002/2003*
NAFTA countries	48.8	55.7	53.3	60.8
Canada	41.1	36.6	44.3	38.1
Mexico	7.7	19.2	9.0	22.7
Asia and Pacific	27.8	17.9	28.2	17.7
Japan	10.9	4.6	12.7	5.1
Malaysia	1.5	3.2	1.8	3.8
China	0.0	1.2	0.0	1.3
Thailand	0.8	0.4	1.0*	0.4
Taiwan	1.6	0.6	1.7	0.5**
Korea, R.	0.9	0.3	1.0*	0.3
Other	12.0	7.6	10.0	6.1
Europe	15.4	21.0	14.3	19.2
Ireland	0.7*	6.3	0.8*	4.1**
United Kingdom	5.7	4.3	4.7	3.6
Germany	2.4	2.2	2.8	2.3
France	1.9	1.5	1.4	1.2
Italy	0.7	0.6**	0.7	0.7**
Other	4.2	6.2	3.9	7.2
Other	8.1	5.4	4.1	2.3
Brazil	2.0*	0.8	2.5*	0.9
All countries	100.0	100.0	100.0	100.0

Source: U.S. Bureau of Economic Analysis, Department of Commerce, www.bea.gov/bea/ai/iidguide.htm#link12b.

Notes
*Either 1989 or 1990 only; **Either 2002 or 2003 only.

direct investment. Had US affiliates in manufacturing industry in Brazil kept their shares in US imports of goods in 2002/2003 equal to their shares in 1990/1991, total US imports of goods from Brazil would have increased 16 percent in 2002 and 13 percent in 2003.

The increase in Mexico's share in US imports from US foreign affiliates in manufacturing industry between 1989/1990 and 2002/2003 was largely due to imports of the transportation equipment industry. US affiliates in Mexico accounted for 9 percent of US imports of affiliates of this industry in 1989/1990 compared with 17.3 percent in 1994, 21 percent in 1998 and 28.5 percent in 2003. Canada seems to have lost relative export capacity as the share of Canada in US imports of goods from US affiliates in the transportation equipment industry declined from an estimated 58 percent in 1989 to 57 percent in 2000 and an estimated 52 percent in 2003.[49]

The share of China in imports from US affiliates of the electrical and

electronics industry rose from zero in 1989/1990 to 2.5 percent in 1994, 4 percent in 2002 and over 5 percent in 2002/2003. US affiliates in Malaysia also increased their share in imports from all US affiliates in this industry, reaching over 20 percent in 2003. However, the share of all the countries in Asia and the Pacific region has fluctuated around 50 percent in the period.[50] Mexico had 22.6 percent of imports from US affiliates of the electrical and electronics industry in 1989, 26.1 percent in 1997 and 18.8 percent in 2000, but is estimated to have reached approximately 30 percent in 2002/2003.[51] Therefore, Mexico has clearly benefited from US foreign direct investments in this industry.

It should be noted that US affiliates accounted for 58.6 percent of total US imports of electrical and electronic products from Singapore to the US in 2003, 39.2 percent from Malaysia, but only 3.3 percent from China. US affiliates accounted for 24 percent of total US imports of electrical and electronic products from Canada in 2001 and 2003, and 25.5 percent from Mexico in 1997 and 2000.

Therefore, generally speaking, the relocation of export capacity of US affiliates in manufacturing industry among foreign countries has been quite consistent with the gains and losses of competitiveness of exporting countries to the US import market.

FDI in China and exports to the United States

China has been one of the world's leading destinations of foreign direct investment. However, official estimates of inward flows and stocks are generally regarded as being overestimated. This is due to the so-called Chinese capital "round tripping", a mechanism by which capital from Chinese residents flows abroad, typically to Hong Kong (HK), and returns dressed as foreign capital to escape regulations and benefit from government incentives given to Foreign Invested Enterprises (FIEs).[52] As a result, Hong Kong (HK) and Macao appear in the official statistics as accounting for 45 percent and 1 percent, respectively, of the total realized FDI in China in the period from 1992 to 2002.[53]

Whatever the portion of FDI that is truly from HK or Macao or, in fact, is originally from residents of mainland China, the fact of the matter is that about half the capital of what is called Foreign Invested Enterprises (FIEs) is held by Chinese residents of HK, Macao or China itself, not to mention Taiwan, which accounted for another 7.6 percent of realized FDI in China in the period from 1992 to 2002. The United States, Japan and the main European investing countries[54] accounted for 8.8, 7.8 and 6.4 percent, respectively, of total FDI in China in the same period.

Considering that exports to the US of Japanese and US affiliates in China accounted for only 5.5 percent in 2001 and 3.3 percent in 2003 of China's exports of electrical and electronic products to the US, respectively, US and Japanese direct investments in China seem to have a very limited capacity to directly explain the gains of China in the US import market. The cumulative value of European FDI in China, being smaller than that of the US or Japan, is likely to also have a very small direct effect on China's exports to the US market.

According to the China Chamber of Commerce for Import & Export of Machinery and Electronic Products, Foreign Invested Enterprises (FIEs), including cooperative, joint venture and solely owned foreign enterprises, accounted for most of China's exports of electronic products in 2002.[55] In household electrical appliances and consumer electronics, FIEs accounted for 57 and 67 percent, respectively, of China's exports. The shares of FIEs in exports of electronic components and automatic data processing equipment were as high as 85 and 86.5 percent, respectively. In telecommunications products, FIEs, especially large multinationals, accounted for over 99 percent of mobile phones, 96 percent of mobile communication equipment and 92 percent of telecommunications parts. The exception was exports of telephone sets, for which State-Owned Enterprise (SOEs) accounted for one-third of exports, while FIEs were responsible 62 percent. Exports based on processing and assembling with imported materials and parts accounted for 70.5 percent of household electric appliances exports, 99 percent of automatic data-processing equipment and 90.3 percent of telecommunications products.[56] The US was one of the main exporting markets for all these electronic products from China in 2002.

Therefore, it is possible to conclude that FIEs, belonging to residents either of HK or of China, are the main exporters of electronics from China to the US market. In point of fact, fourteen Chinese companies show up among the top 300 electronics companies in the world in 2003, according to electronics revenues recorded in calendar year 2002.[57] One Chinese company was in the top fifty, three in the top 100 and six in the top 150. In 2000, there were nine Chinese companies in the top 300.[58]

Although Japanese, North American, European and Taiwanese affiliates in China do not account directly for a significant share of Chinese exports to the US, they and their parent companies are often regarded as essential for the competitiveness of Chinese companies. The trade intensity and the formation of international production and distribution networks in East Asia are well known and play an important role in the development of Chinese electronics companies.[59] Just as an example, it is said that "of Taiwan's $50.52 billion output of IT products in 2003, 63.3 percent was produced in China".[60]

Inward FDI in Mexico and Brazil

It has already been shown that Mexico has benefited enormously from the expansion of export capacity of US affiliates in the country, especially in the automotive and electronics industries, as well as from Japanese FDI in the automotive industry. Indeed, although Brazil has received a larger inflow of FDI than Mexico, to a large extent as a result of a huge privatization program in telecommunication services, Mexico appears to have received a much greater inflow of FDI in manufacturing industry, as Table 12.8 reveals. According to ECLAC (2004), however, Brazil appears to have received a larger volume of FDI in the automotive industry from 1994 to 1999 than Mexico.

However, more important than the inflows of foreign direct investment is the

Table 12.8 Foreign direct investment ($ million)

Brazil	*Total*	*Manufacturing industry*	*Electrical and electronics industry*	*Automotive industry*
1985–1993	12,282	8,409	–	–
1994–2004	193,910	53,909	–	–
1999–2004	128,714	40,573	5,804	7,914
Mexico	*Total*	*Manufacturing industry*	*Electrical and electronics industry*	*Automotive industry*
1985–1993	29,475	13,065	–	–
1994–2004	150,607	73,746	–	–
1999–2004	103,312	45,418	9,501	9,447

Source: Central Bank of Brazil for Brazil and Secretaria de Economia and INEGI for Mexico.

Notes
Sum of the annual inflows of FDI, except for manufacturing industry in Brazil which was based on the share of manufacturing industry in total FDI calculated by differences in stocks. This share was then applied to the sum of total annual inflows.

fact that Mexico has become an export platform under NAFTA. On the other hand, Brazil has maintained an inward orientation for both the electronics and automotive industries at the MERCOSUR level, through high common external tariffs and foreign-trade compensation for automobiles among MERCOSUR members.[61] However, as far as US multinationals are concerned, even the value-added of US Majority-Owned Nonbank Foreign Affiliates (MOFAs) was much higher in Mexico than in Brazil in 2002 and 2003, especially in transportation equipment, computers and electronic products, and electrical equipment, appliances and components. The value-added of US MOFAs in Brazil was higher than in Mexico in machinery and primary and fabricated metals.[62]

Concluding remarks

The changes in the US merchandise imports by countries have, to some extent, been the result of a phenomenal relocation of Japanese industrial production, only partly affected by NAFTA. Indeed, the strategic decision of some large Japanese companies to invest heavily in new plants in North America occurred in the early 1980s, well before NAFTA, but the process of relocating the production capacity of Japanese companies away from Japan and towards North America deepened under NAFTA. It is this relocating process that is the main factor behind the decline in the share of Japan in US imports of goods. The share of Japanese companies in the US market does not appear to have declined, as sales of Japanese affiliates in the US offset the relative fall in exports, especially in the automotive and electronics industries.

The spectacular rise in the share of China in US imports has been made possible by large inflows of foreign direct investments into China. However, most

of these investments have been from residents of Hong Kong and/or mainland China. The shares of Japanese and North American affiliates in China in exports to the United States have been relatively small and are not significant enough to explain China's huge gains in market share in the US import market. On the other hand, Chinese companies in the electrical-and-electronic industry have been climbing up the list of the world top companies in electronics revenues and have a large share of their sales from exports to the US market.

Exports of Mexico to the US, especially of products from the automotive and the electrical and electronic industries, have clearly benefited from NAFTA, largely due to foreign direct investments from North America and, to a much lesser extent, from Japan. Mexico's competitiveness gains in the US import market in 1992–2004 were due entirely to the gains in 1992–1999, since Mexico lost competitiveness in 1999–2004. This suggests that an FTA with the US, however well negotiated, may boost inward FDI and exports, but is not a free ticket to long-term development. Whatever the initial positive effect of an FTA, it must be followed by an environment conducive to the continuing transfer of technology from abroad and to both human and physical capital growth.

Therefore, the local sales of Japanese affiliates in the US, and US imports from US affiliates in Mexico and Canada, are quite consistent with the losses of competitiveness in the US import market of Japan and Canada, and the gains of Mexico. Although China has also benefited from Japanese, North American and European foreign direct investments, Chinese gains of competitiveness in the US import market are more directly related to exports of Chinese companies (Original Equipment Manufacturers – OEMs), especially in the electronics industry.

The negative effects of NAFTA on Brazil's exports to the US have been significant and much larger than anticipated. US imports shipped by US affiliates have been diverted away from Brazil, while US affiliates in Mexico have sharply increased their share in US imports. Brazil has been missing opportunities to further open its economy, improve its business environment, and thus become more attractive to foreign direct investments, particularly in manufacturing industry.

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Notes

1 The analysis may be extended to include several destination markets.
2 See Fagerberg and Sollie (1987) for a presentation of the CMS model using vector notation.

3 See Leamer and Stern (1970) for a detailed and critical analysis of the CMS model. Their version of the model focuses on changes in export revenue rather than on change in market share. As a result, a demand effect appears in their version. But if the demand effect is subtracted from the change in export revenues, the result is the difference between actual export revenue at the end of the period and the value that would have been necessary to maintain the macro share of the exporting country constant. This, in turn, is equal to the change in market shares times the size of the import market at the final year.
4 See Chami Batista (2007) for a step-by-step description of the method of attributing a country's gains and losses of competitiveness to competitors.
5 See Chami Batista (2006) for graphs showing these time series.
6 In Chile, most of Mexico's gains, but not all, proved to be only temporary.
7 Mexico's share of the Chinese import market shows a rising trend after 1999, though from a very small base.
8 The share of China in import goods of the EU (15) market rose continuously from 0.7 percent in 1989/1990 to 1.7 percent in 1994/1995, 2.7 percent in 1999/2000 and 4.4 percent in 2003/2004. Similar performances occurred in the import goods markets of Brazil, Canada, Chile and Mexico, starting with less than 1 percent in 1989/1990 the share of China rose to between 5.5 percent in Brazil and 7.9 percent in Chile. The share of China in Japan's imports of goods rose from 5.2 percent in 1989/1990 to 20.2 percent in 2003/2004. Data are from the United Nations, Comtrade database, http://unstats.un.org/unsd/, accessed in November 2005.
9 Data for US imports by country of origin are based on a five-digit product of the Standard International Trade Classification (SITC), Revision 3, Imports for Consumption, Customs Value (FOB), from the United States International Trade Commission – USITC.
10 Although all tariffs on US–Canada trade in goods originating in the two countries were only eliminated as of 1 January 1998, "much of trade within US multinational companies between the United States and Canada had already been tariff-free under the provisions of the 1965 United States–Canada Auto Agreement" (Zeile, 2003: 12).
11 Gains or losses in 1992–1999 are calculated by the difference between the figures for 1992–2004 and 1999–2004.
12 Five-digit SITC, Revision 3.
13 Electronic products or industry includes computers, telecom equipment, electrical equipment and appliances, and consumer electronic products or industries.
14 Recall that the competitiveness effect is calculated by the difference in market shares times the value of the import market at the final year – i.e. 2004.
15 The main products were automobiles (18 percent) and trucks (SITC 78120 and 78219); computers (75230 and 75260); boards for electric control or distribution of electricity (77261); cellular phones (76432) and radio receivers with sound recording apparatus (76211).
16 The automotive industry accounted for 58 percent of Japan's losses to Canada, with only cars (SITC 78120) accounting for 48 percent and trucks (SITC 78219) for 6 percent.
17 As we already know, Mexico's losses of competitiveness were concentrated in 1999–2004, especially after 2002.
18 According to SITC: computers (75230 and 75260); transmission apparatus and cellular phones (76431, 76432); lighting fixtures (81311); padlocks and locks of metal (69911); ignition wiring sets used in vehicles and other electric conductors (77313 and 77315); articles of apparel and clothing accessories (84).
19 That is against all competitors taken as a group, including Mexico.
20 See Chami Batista and Azevedo (2002) for a similar result for the period 1992–2001.
21 Related party trade includes trade by US companies with their subsidiaries abroad as well as trade by US subsidiaries of foreign companies with their parent companies.

The definition of related party for imports is based on an ownership share of at least 6 percent; see Zeile (2003: 1).

22 Exhibit 4 – Imports for Consumption for Selected Four-digit NAICS Codes: 2004; US Census Bureau News, US Department of Commerce, 12 April 2005. These data may contain a bit of double-counting in special cases where a US parent company is itself a foreign-owned affiliate; see Zeile (2003: 8).

23 Overall related party share of imports has remained relatively constant since 1992, varying only from 45 to 48 percent of imports. Related party trade with Canada, Mexico and Japan has also remained quite stable as a proportion of US total imports of goods from these countries, but the related party shares of Korea, Taiwan, China and Eastern Europe have shown a substantial increase since 1992. See US Census Bureau News, US Department of Commerce, 12 April 2005.

24 This figure was obtained by converting the annual figures from yen into dollars using the average exchange rate from the IMF. The total outward direct investment from Japan was 87,587 billion yen in the period. See Ministry of Finance of Japan: www.mof.go.jp/english/e1c008.htm.

25 These percentages are based on values in yen.

26 Although total Japanese outward FDI per year fell in 1999–2004 compared with 1989–1998, Japanese outward FDI in manufacturing industry per year actually increased when these subperiods are compared, both in current yen and current US dollars.

27 The fact that the UK accounts for a large part of the relative rise in Japanese FDI in Europe in the period 1999–2004 suggests that this move was not related to the monetary union of Europe. The relative rise in the UK as a destination for Japanese FDI was largely due to investments in the food industry. The Netherlands, which together with the UK accounted for most of the relative rise in Japanese investments in Europe, received a large proportion of Japanese investments in transportation equipment, electrical and electronics, and chemical industries. The share of Japanese investments in the transportation equipment industry also went up in France, Belgium and Sweden. In Ireland, the relative rise has to do with the chemical industry, which accounted for 78 percent of Japanese investments in manufacturing industry in that country from 1989 to 2004 and for 95 percent in the period from 1999 to 2004. As already seen, the chemical industry also accounted for 78 percent of Japan's losses to Ireland in the US import goods market in 1992–2004.

28 The competitiveness gain of China in the US import market of auto parts (SITC 784) totaled $1.3 billion in 1992–2004, of which 75 percent took place in 1999–2004. The main losers to China were Canada (44 percent), Japan (25 percent), Mexico (10 percent), and Germany (5 percent).

29 For a review of these negotiations, see Ichira (2005).

30 See JAMA (2005a); McAlinden and Swiechi (2005).

31 The Japanese cumulative investment in US auto and auto parts manufacturing plants grew from $11 billion in 1993 to $28 billion in 2004, while the number of plants grew from eleven in 1993 to twenty-five in 2004 and is expected to rise to twenty-eight in 2006. See JAMA (2005b).

32 Including trucks, import penetration from Japan in the US was 19 percent in 1985, 14.2 percent in 1992, and 8.2 percent in 1997. Import penetration is calculated as units imported over sales in the US market.

33 Locally built cars plus imports.

34 Data are from AAMA (American Automobile Manufacturers' Association), www.economagic.com/aama.htm, accessed in November 2005.

35 See McAlinden (2004).

36 For 1985 and 1992 data are from AAMA, and for 2003 from McAlinden (2004).

37 See Survey of Japanese Foreign Affiliates (Kaigai Jigyo Katudou), Ministry of Economy and Trade of Japan, available only in Japanese. Of 14,991 Japanese foreign affiliates from all industries and countries, 62.9 percent responded to the survey.

38 See Jetro (2003).
39 "Among textile plants, as much as 47.1 percent indicated the plan to stop manufacturing in the US as a result of increased influx of imports from China", Jetro (2003: 13).
40 See Survey of Japanese Foreign Affiliates (Kaigai Jigyo Katudou), Ministry of Economy and Trade of Japan.
41 See Jetro (2004), p. 21.
42 Figures in parenthesis refer to the ratio of domestic production in Japan in 2000 and 2003, or just 2003, see Jetro (2004: 22).
43 Electronics revenues are based on segmentation information and Reed Research Group estimates. Electronics revenues include revenue from the sale, service, license, or rental of electronics/computer equipment, software or components. Reed Research Group, e-inSITE Yearbook 2003, www.reed-electronics.com/electronic news/ index.asp?layout=article&articleid=CA278896, accessed November 2005.
44 The share of US imports from US affiliates in total US imports of goods was 20.6 percent on average in the three years from 1989 to 1991 and 18.6 percent in the three years from 2001 to 2003. See Bureau of Economic Activity, US Direct Investment Abroad, Tables Tab2H22 for 1989, Tab18 for 1990 and 1991, and Tab2I19 for recent years.
45 There are no data available for Singapore in 2002 and 2003, but it is possible to see that the shares of this country in US imports shipped from all US affiliates in the manufacturing industry rose from 2.0 percent in 1989/90 to 8.6 percent in 1998, falling then to 6.8 percent in 2001.
46 In fact, the share of Canada actually fluctuated up to the mid-1990s before showing a clear declining trend. This is in line with the share of Canada in US total imports of goods as shown in Table 12.1.
47 Again, there are no data for 2002 and 2003, but the share of Hong Kong fell from 6.0 percent in 1989/1990 to 3.0 percent in 2001.
48 Waldkirch (2003: 153) provides econometric evidence that "NAFTA has had a significantly positive effect on FDI in Mexico, due almost entirely to raising investment from the United States and Canada."
49 Due to data confidentiality, there are no figures for US affiliates in transportation equipment industry in Canada in 1989 and 2003. The share of US imports from affiliates in other manufacturing industry in 1989 and 2003 had therefore to be estimated on the basis of the shares in 1991/1992 and 2000, respectively. The share in transportation equipment industry was then roughly estimated as a residual.
50 The share of Singapore in US imports of electrical and electronics from US affiliates fell from a peak of 21 percent in 1990 to 6.5 percent in 1998, went up again to 28.8 percent in 1999, but declined continuously after that to reach 14.2 percent in 2003.
51 Due to data confidentiality, there are no figures for Mexico in this industry in 2002/2003. The share of it was roughly estimated by the difference between the figures for manufacturing industry and for all other industries. Whenever there were no data available for the other industries, their shares in manufacturing industry for other years (2001, 2002 or 2003) were applied.
52 Estimates of this type of capital vary from 26 percent to 54 percent of total FDI. The incentives include a corporate tax rate applied to FIEs of 15 percent for three years, after a two-year tax holiday once they have recorded a profit, compared with a standard 33 percent rate for domestic firms, as well as duty-free concessions for imported equipment, improved land use rights and other advantages. See Erskine (2004), Xiao (2004) and World Bank (2002).
53 See Chantasasawat *et al.* (2004: 9).
54 It includes the UK, Germany, France and the Netherlands.
55 See China Chamber of Commerce for Import & Export of Machinery and Electronic Products (2004). According to Lall (2004), "the foreign investor's share of China's total exports is estimated at 55 percent in 2003". Furthermore, according to a report

by iSupply, "China's manufacturing market is mostly fragmented. Fifty-seven percent of the electronic equipment manufacturing is done by foreign OEMs. Another 29 percent is done by the top thirty Chinese OEMs. All told, local companies produce only 36 percent of the electronics revenue in China. Except for the top thirty large manufacturers, relatively small local companies do much of China's manufacturing", see "China's Share", Rob Spiegel, *Electronic News*, 12/15/2004, www.reed-electronics. com/electronicnews/article/CA488063?text=ce+and+china, accessed in November 2005.

56 See China Chamber of Commerce for Import & Export of Machinery and Electronic Products (2004). According to iSupply, "Chinese OEMs already dominated most consumer-electronics markets in China, but now are gaining prominence in other product areas, including mobile communications. Last year, Chinese OEMs were the top producers in that country of ADSL modems, air conditioners, central-office switches, desktop PCs, television set-top boxes, entry-level servers, microwave ovens, MP3 players, notebook PCs, refrigerators, telephones, televisions, USB flash drives and washing machines. Non-China-based OEMs led production in CRT monitors, digital still cameras, mobile phones, ink-jet printers, laser printers, LCD monitors, dot-matrix printers and mobile-communications base stations", Chinese OEMs Lead Domestic Markets, *Electronic News*, 9/21/2004, www.reed-electronics.com/electronicnews/article/CA454520?text=non%2Dchina+based+oems.

57 This was before the consumer electronics manufacturer TCL, a large Chinese OEM, took majority control over Thomson's television business near the end of 2003 and Chinese computer maker Lenovo acquired IBM's PC business in 2005. As to exports, telecommunications gear maker Huawei, another top Chinese indigenous OEM, competes directly with Cisco, Lucent and Alcatel and projected that 40 percent of its 2004 revenues were derived from sales outside of China. See Electronics News, "Chinese OEMs Show Strong Growth", 02/15/2005.

58 See Electronics Industry Yearbook, ed. 2002, and Reed Research Group, e-inSITE Yearbook 2003, www.reed-electronics.com/electronicnews/index.asp?layout= article&articleid=CA278896, access in November 2005.

59 See, for instance, Kimura and Ando (2004).

60 See Jetro (2004: 17).

61 For a comparison between the automotive sectors of Brazil and Mexico, see ECLAC (2004), pp. 113–133.

62 See Mataloni (2005: 28–29).

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13 Beyond FTAs

Deepening North American integration

Wendy Dobson

Negotiations for a Free Trade Area for the Americas are an important step along the road to Western Hemispheric integration. The alternatives are multilateral liberalization or market-driven integration, a route followed in East Asia for many years. Indeed, as integration deepens in the European single market project, free trade agreements (FTAs) are coming to be regarded as relatively modest starting points for intergovernmental arrangements. Even so, in some Latin American countries significant political reservations remain about this route to better market access within the hemisphere; neither are special interests silent in North America.

Presented in this paper is a Canadian perspective on North American integration in the light of major changes in the world economy since the implementation more than a decade ago of the Canada–US FTA and NAFTA. These changes highlight the need for completion of these FTA projects by totally eliminating tariffs and other border barriers and pursuing deeper economic integration that respects and preserves national sovereignty. I begin with a view of these changes. I then explore the challenges for North America as China and India become major players in global production systems in manufacturing and services and follow with an analysis of some of the implications for North American integration. I conclude that the rapid rise of China and India should be a catalyst for deeper integration in North America and, indeed, for a single market in the hemisphere.

Historically, Canada and the United States have had a close and mutually beneficial economic and security relationship. The Canada–US free trade agreement (FTA) was negotiated in 1987 and was subsequently the focus of intense political debate in the 1988 national election in Canada. Yet the FTA, when it was implemented in 1989, placed the economic dimension of the relationship on more secure footing than ever before. This foundation was extended under NAFTA to include Mexico.

The core of the FTA was not just the elimination of tariffs on merchandise trade and the inclusion of services and foreign direct investment, but the creation of rules for dispute settlement that were later adapted to NAFTA. NAFTA was phased in during a period of unprecedented growth and dynamism in the US economy in the 1990s and Canada–US merchandise trade doubled in the first decade after the agreement.

The world has changed

Since the negotiations, the world has changed in at least four ways. First, global production systems were in their infancy at the time of those negotiations. Today, information technology innovation and advances in logistics have made possible the vertical dis-integration or segmentation of most commodity manufacturing and many services, locating each activity in the value chain where it can be most efficiently performed. Second, services trade has grown in importance (if not in ease of measurement). By 2004, commercial services trade was 23 percent of world merchandise trade, 20 percent of total trade within NAFTA and around 10 percent of Canada's total merchandise trade with the United States. Third, China and India have rapidly integrated into the world economy as domestic reforms, and in China's case accelerating value of foreign direct investment inflows over the past decade, drove such integration. Fourth, these trends had emerged before 11 September 2001, but those tragic events brought home the extent to which the flip side of openness necessary for deeper integration is increased vulnerability to disruption.

The three North American economies have only begun to deepen and formalize their economic interdependence. After the terrorist attacks, the near-closure of the US border and growing border congestion acted like a higher tariff, raising both business transactions costs and the uncertainties of managing cross-border supply chains. Border closings – distinct possibilities in the event of a future terrorist attack – illustrate how fragile are the legal and institutional frameworks for the North American relationship going forward.

The depth of economic interdependence in North America is illustrated by the fact that Canada and Mexico depend on the US market for between 80 and 90 percent of their exports; the United States sends 40 percent more of its exports to its two immediate neighbors than to the fifteen main EU members. The auto, steel and energy sectors of the North American economy are now deeply integrated, due to a combination of market forces and the merchandise trade focus of intergovernmental agreements.

These changes in the world economy – growing insecurity and intensifying international competition – imply that the imperatives of North American, and indeed hemispheric, negotiations should be to deepen integration to reduce as many of the remaining barriers to factor and product flows as possible to realize the ideal – one price within the area – and to reduce costs and allow the exploitation of scale economies and movements among the growing knowledge agglomerations located in North America. We need a vision of a secure economic space common to three sovereign countries in which goods, services, capital, people and ideas flow freely – to provide new strategic opportunities for businesses and more and better jobs for people.[1] Using the advantages of the "neighborhood" to meet global competitive challenges is a superior strategy to going it alone.

The challenges of global production systems

Consider the context for this vision in which the changing face of global competition dominates. UNCTAD and WTO analysts and others have thrown light on offshoring of manufacturing and services. China's attractiveness for standard technology manufactured goods assembly has been celebrated; India's successes in supplying call center and information technology services slightly less so.

The magnitude of the competitive challenges to North American economies from China and India is illustrated by some empirical examples. China's rapid export surge of manufactured goods has affected import competing producers and their unskilled labor forces. A USITC study[2] made public around NAFTA's tenth anniversary examined the structure of import competition in the US merchandise trade over the 1998–2002 period. In 2002, the authors found 51 percent of total US imports were fairly evenly distributed among Canada (with an 18 percent share), Mexico (12 percent), Japan (10 percent) and China (11 percent).

Among the interesting findings in this study were the relative growth rates of those import shares over the previous five years: Canada's share grew at a 21 percent rate; Japan's was stagnant; Mexico's grew 44 percent, while China's share grew by 76 percent. In footwear, China's share was 67 percent in 2002 with a growth rate of 28 percent during the previous five years, while Mexico's 2 percent share resulted from a negative growth rate of 20 percent over the period. Apparel showed the same story. Auto parts, which are so important to Canada and Mexico, showed each had a 25 percent share; China a minuscule 2 percent, but China's growth rate was 174 percent compared with Mexico's 43 percent and Canada's 21 percent. What these numbers help to illustrate is the shock to traditional suppliers administered by the speed of China's penetration of the US market. We are all familiar with the shock to producers based in the US itself. I suspect similar trends would be found in Latin American economies.

Some students of services offshoring predict that it is likely to deliver a larger shock to the US economy than offshored manufacturing has done because it will be something that US CEOs do to their own workers in order to remain competitive.[3] While the impact on total employment is still small, they argue that the shock will come through downward pressures on real wages in the jobs that remain in North America, and the impact on white collar workers with political voice. At the same time, however, as WTO (2005) analysis shows, lower costs of imported inputs reduce costs and raise productivity, allowing for higher rewards to domestic workers. Which effect is the stronger is the empirical question that requires much more research. What is certain is that some workers will be dislocated, and ways should be found to ameliorate their distress. Hufbauer and Schott (2005) review adjustment assistance programs in the three NAFTA countries and conclude that Canada's are adequate, but the 2002 version of the Trade Adjustment Assistance Act needs to expand worker eligibility and increase the generosity of health insurance subsidies and wage insurance.

Canadian evidence from recent plant level studies casts some additional light

on these issues. Increased competition following trade liberalization pressured managers to intensify their strategic focus. They reduced product lines, probably through offshoring, which helped to reduce costs, increase profits and invest in more R&D, which of course also contributed to enhanced productivity performance.[4]

UNCTAD (2004) estimates that between 1992 and 2002 US imports of selected business, professional and technical services grew at a 7 percent annual rate and totaled about $205 billion. Most service providers were concentrated in Ireland, India, Canada and Israel, which in 2001 accounted for 71 percent of the market. This analysis includes services offshoring which requires foreign direct investment by companies in affiliates and local service providers (as distinct from trade).[5] These activities are divided by value-added into call centers at the low end; shared service centers requiring more advanced skills in accounting, programming and data analysis; IT services such as business processes, design, software development requiring advanced skills and specialization; and regional headquarters where head office functions are carried out. By 2003, developing and transition economies accounted for 51 percent of such foreign direct investment projects.

What is notable about Canada is that it attracted 12 percent of the call centers installed during the study period and only 2 percent of the higher value added information technology service centers – in other words, it is still stuck at the low end of the value chain.[6] Only 2 percent of the foreign direct investment projects were undertaken in Brazil, Chile and Mexico. UNCTAD (2004) further noted that among the world's 1,000 largest companies, as many as 70 percent have not yet offshored any business processes – the implication being that there is still a long way to go, with opportunities for improved competitiveness in sending countries, and more jobs, skills and market access for receiving countries.

I cite these statistics to make three points. First, some aspects of global supply chains are possible without liberalization of trade and investment. Indeed, India's historically restrictive policies towards merchandise trade and foreign direct investment were a significant impetus for some of India's leading entrepreneurs to focus on what goes on *inside* computers, driving what became India's information technology services revolution. Second, global supply chains in manufacturing *are* dependent on trade liberalization, as is foreign direct investment in offshore services affiliates. In Asia, much of that liberalization has been unilateral. Third, the distance still to go in services offshoring suggests a potentially disruptive impact over time on the importing and investing countries. The major implication of these changes, though, is not to protect against such competition, but to adjust. The premium on domestic economic flexibility is high and rising, creating urgent domestic policy reform agendas and raising the stakes to maintain the momentum of trade liberalization.

The implications for North American and FTAA agreements

Deepening the now-dated trade liberalization agreements will have to recognize that security and economics are now intertwined in North America. Canada and the US have a long history of working together on these issues, going back to the North American Aerospace Defense Command and North Atlantic Treaty Organization, and more recently on the 2001 Smart Border Accord.

The next steps require a vision of a common North American economic space made up of three sovereign countries and one economic system that reflects the enormous stake each of us has in the others' welfare – and an action plan. Topping the action plan is what Michael Hart, Allan Gotlieb and I call "completing the free trade project" by eliminating border tariffs completely and adopting a common external tariff. Another item in the action plan is to move the border away from the border by using modern technologies for pre-clearance and high-technology screening of low-risk frequent travelers. Yet another element is to address differences in regulatory regimes by getting rid, unilaterally if necessary, as we are contemplating doing in Canada, of regulations and standards that do not serve any safety purpose beyond "being different" but that inhibit cross-border trade and investment. Another item is to find ways to replace US trade remedies with a single North American competition policy and rules about subsidy practices. Finally, we need new institutions of governance and conflict resolution.[7] One of the institutions should be annual leadership summits. The summit held here at Baylor University in March 2005 should not be a one-off, but rather the beginning of regular attention at the top to the realization of the common vision. A more comprehensive security-economic agenda has been proposed by a three-country study group sponsored by the Council on Foreign Relations in 2005.[8]

The implications are pretty clear: freer access to one's neighbors' markets allows businesses to exploit economies of scale and develop new business strategies that include services offshoring. In Canada, for example, we should recognize that offshored services not only reduce costs, but also allow companies to improve the quality of their services. If we are to meet the intense competitive challenges we face from new competitors, we also need to move up-market to higher value-added services. For us, and I suspect for most other economies in the hemisphere, the productivity objective inherent in higher value-added goods and services requires knowledge and technology. The United States is our hub, and its innovations are ones that China and India accept and adapt; we in the Western Hemisphere should do more of this than we do. Freer flows of capital, technical and business people, as well as goods and services, are also required. Of course business strategies require knowledge of the risks and how they will be managed, so credible dispute settlement procedures are also essential.

At the same time, each country should examine its own domestic policy environment and assess the effectiveness of its education and innovation systems, its framework policies and social safety nets for their effectiveness in promoting adjustment. Canada's commitment to education and basic and applied

research has increased in recent years. However, much more needs to be done to restructure the tax system to encourage saving and reward risk-taking by businesses. Major policies, such as those governing financial institutions, need to be changed to allow productivity growth in major sectors.

The WTO (2005) reports that in the two biggest success stories, Ireland and India, governments strongly supported the rise of the information technology sector (although in India it was largely ignored until it had become established) with framework policies and a combination of specific policies, including trade liberalization for imported inputs, removing restrictions on foreign direct investment, favorable taxation, and low-interest export credits.

Finally, I will comment on Canada's revealed stance towards deepening NAFTA and the FTAA. Briefly stated, the official policy stance is one of incrementalism: small changes, a lot of talk, and not much action.

On NAFTA deepening, Canada's talk sounds good; it includes a menu of activities that are pursued incrementally. Yet this approach fails to take into account the diffused nature of the US political system, which is unable to deal with incrementalism. Instead it responds best to big packages that are championed across a sufficiently large set of interest groups that competing interests cancel each other out.

The Waco summit of the leaders of Canada, Mexico and the United States was a missed opportunity for developing a more ambitious North American integration agenda. Any bold initiatives must come from Ottawa and Mexico City if they are not to be dismissed as part of a hidden agenda of the dominant US partner. But domestic political considerations in both Canada and Mexico inhibited their leaders from initiating new ideas, despite President Bush's reported interest.[9] The resulting Partnership for Security and Prosperity is only a modest step forward, with responsibilities delegated to ministers and officials. A holding action is most likely in the next year in light of the 2006 electoral calendars in the three countries.[10] In the meantime, the United States pursues a lengthening list of bilateral FTAs that either exclude Canada and Mexico or relegate them, as in the case of Chile, to a hub-and-spoke arrangement.

Not unrelated is the fact that the bilateral relationship has become a main street issue in Canada because of a widespread conviction that the US administration has failed to abide by the dispute settlement rules agreed to in the FTA and the NAFTA negotiations. Because of the many disputes channeled through both the WTO and NAFTA dispute settlement mechanisms, even though separate issues and on separate tracks, the situation has become so muddied that some extraordinary political action is needed to find a permanent resolution before it irreparably damages the relationship. The absence of an overarching vision for the relationship and badly managed (though domestically popular) Canadian decisions to step aside from the Iraq conflict and the BMD initiative are probably part of the reason for a lack of US administration commitment to resolving the impasse. The United States should live by the rules of agreements that it has signed. But Canadians could also engage in more astute and adept management of the relationship.

What does all this mean for the FTAA? At the broadest level, global production systems work best when business decisions about locations for dispersed activities are based on market signals. The proliferation of bilateral agreements in the past few years has increasingly troublesome consequences for these systems. The complexities of differing rules of origin, for example, distort business decisions and raise costs and prices as firms become preoccupied with (i) keeping track of multiple rules and (ii) conforming business decisions with rules rather than with products that are most cost-effective for the final consumer. The advantages of the economic diversity in the Western Hemisphere that might attract global production will be enhanced by one set of rules rather than a Western Hemisphere “spaghetti bowl”.

Some governments have yet to recognize this fundamental potential benefit of the FTAA. There is considerable official enthusiasm for promoting democracy and growth; for the principle of market access within a $17 trillion market and 800 million people; for better protection of investors, opportunities in services and a region-wide dispute settlement mechanism. But the existing level of integration is low – in Canada’s case, so low that trade with Latin America and the Caribbean is not broken out of trade statistics with the rest of the world. Indeed, more official energy is going into a bilateral agreement with South Korea. Still, the initiative to liberalize trade and investment is worth pursuing if it provides impetus for continued domestic reform and opening.

In conclusion, as global business becomes increasingly disaggregated, the opportunities for deeper integration among neighbors, about which businesses have more knowledge than they do of more distant opportunities (the gravity effect in trade theory), should be exploited by businesses and facilitated by public policy. This was a major rationale for the North American FTAs. They have brought considerable benefits but now need to be deepened further to address new competitive and security challenges. It is also a rationale for the FTAA. The re-emergence of the world’s two largest countries, China and India, as dynamic competitors in global production systems will, sooner or later, be a catalyst for deeper integration in the hemisphere. The two projects, North American and hemispheric, need not be mutually exclusive.

Notes

1 See Dobson (2002); Council on Foreign Relations (2005) among others.
2 Watkins (2003).
3 See Cohen and Delong (2005).
4 Discussed in Trefler (2005: 32).
5 UNCTAD (2004).
6 Pointed out in Trefler (2005).
7 Gotlieb *et al.* (2005).
8 Council on Foreign Relations (2005).
9 As Hufbauer and Schott (2005: 491) conclude, it makes sense for the Canadian and Mexican leaders to agree on agenda items between themselves and then make a joint demarche to Washington.

10 Canada will have a national election in January 2006; Mexico faces a presidential election in mid-year; and US mid-term elections occur in November 2006.

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Part V

Interaction of regional and global trade agreements

14 Interactions of regional and global trade agreements

Sylvia Ostry

Introduction

The title of this session – interaction of regional and global trade agreements – resembles that wonderful example of American hyperlexia: it depends on what the meaning of "is" is. Interaction depends on what piece of post-war trade policy we are studying. I have called pre-Uruguay Round "competitive liberalization" domino policy. Today's competitive liberalization is a very different matter. Maybe it could be termed spaghetti policy? Presented here first is a brief review of the major aspects of the pre-Uruguay policies and the current state of play, and then some considerations for regionalism and multilateralism.

Dominos and spaghetti

While the Europeans demonstrated a marked addiction to preferential trade agreements (PTAs) in earlier decades, this was largely a form of post-colonial foreign policy since trade was the only "foreign" policy allowed under the Treaty of Rome. The main architect of regional domino policy was the United States, which initiated its multi-track trade policy in the 1980s with Canada (CUSTA) because the multilateral negotiations were stalled due to the fight with Europeans over agriculture, and with a number of developing countries (the "G10 hardliners"), led by Brazil and India, over the "new issues" of services, intellectual property and investment. A major objective for the US in CUSTA was to demonstrate to the Europeans that bilateralism was a feasible alternative if their foot-dragging at the GATT continued. In order to send a message to the G10, the President initiated the use of an obscure Section 301 of the 1974 Trade Act. So the multitrade policy was unilateral, bilateral and multilateral. But that is another story.

Was CUSTA successful in stimulating progress in the multilateral trading system? That, of course, cannot be proved, but it may have helped by adding to the internal pressure for reform of the CAP (Common Agricultural Policy). Indeed, the Uruguay Round was launched in Punte del Este in September 1986 – at precisely the same time that CUSTA was announced in the Canadian House of Commons.

On the matter of bringing countries to the table to discuss new issues, the scorecard was one out of three. CUSTA provided a major breakthrough in trade in services and provided the basic template for the GATS (General Agreement on Trade in Services).

Then NAFTA became the second domino. Intellectual property had been excluded in CUSTA because of conflict over compulsory licensing in Canada. NAFTA nailed down Mexican reforms on patent and copyright. But the really big victory was investment. One could plausibly argue that NAFTA was more about investment than trade. However, when investment was taken to the Organization for Economic Cooperation and Development *en route* to Geneva, the MAI (Multilateral Agreement on Investment) collapsed. The domino became a boomerang, and quite a powerful one considering the subsequent history of failure to get comprehensive investment rules in the WTO. It also provided the spur to the non-governmental organizations claiming victory in the death of the MAI and then gearing up for the Battle of Seattle.

So what is the scorecard on this episode of competitive liberalization? One could say "so-so" or "not bad" or "do not know." But it was a coherent policy of the US, and was intended to use preferred trading agreements (PTA) as building blocks for multilateralism.

Today, however, the metaphor is no longer dominos, boomerangs or building blocks. The proliferation of PTAs since the mid-1990s is astonishing. The metaphor is now spaghetti. The confusion in the system generated by rules of origin (ROOs) is particularly punitive for small firms and small countries, but, given growing vertical production networks, the transaction costs are such that most large firms would rather apply MFN.

The most significant aspect of this new phase of "competitive liberalization" is the dominance of the US. It is difficult to discern a coherent policy, either economic or political, in the plethora of US bilaterals across the globe except, perhaps, in the prevalence of WTO plus agreement for intellectual property and investment. It is easier to include these items in bilaterals with smaller countries because of the immense asymmetry in negotiating power. But what is WTO-plus in a PTA is likely WTO-minus in Geneva. The result is serious and growing fragmentation of the rules-based global system. Fragmentation and globalization are a poor match.

Policy options

Before turning to the Doha Round and the Hong Kong trade ministerial meeting, it is important to recognize that regional economic integration can play a positive role in enhancing the global system. South–South agreements could be particularly useful. However, more than trade is involved. We tend to think that there is only one route to deepening integration, i.e. trade and investment. In the Western Hemisphere, policy and institutions have played a minimal role. Yet most experts agree that inequality and poverty, as well as widespread crime and corruption in many countries, pose a serious threat to the sustainability of demo-

cracy. Since the Washington consensus is passé and "second-generation" reform has shifted to neo-institutionalism, surely some projects could be launched with or without the US in MERCOSUR or CAFTA or wherever. Some projects already exist, such as IIRSA (Integration of Regional Infrastructure in South America) and the Puebla-Panama Plan launched in 2002 with Interamerica Development Bank support. Careful monitoring and analysis could yield extremely important insight not only into best practices but also into the vital link between infrastructure and growth. In rural areas, infrastructure is essential if farm productivity is to improve: trade policy is pointless if you cannot get your product to the market.

Regional infrastructure is a project of high priority, but there are many others that could be listed. And economies of scale in regional institutions can be considerable. What is needed is to get away from the mindset that regional integration is only about trade. As one scholar has noted, NAFTA made no provision for infrastructure, and the resulting delays because of increased traffic "have raised the transaction costs of regional trade more than the elimination of tariffs have lowered them."[1] In the Council on Foreign Relations task force report, *Building a North American Community*, there is a proposal to establish a North American investment fund for infrastructure and human capital.[2] While I am skeptical that anything much will come of this North American Community idea (like Sydney Weintraub, I fear that the outcome will be "actionless talk"[3]), still it is worth noting that the importance of improving infrastructure and human capital in Mexico was at least recognized. Maybe this recognition dawned with the realization that NAFTA's first decade resulted in increased North–South and rural–urban inequality in Mexico.[4]

Finally, let me turn to the Hong Kong trade ministerial meeting. Lacking an effective crystal ball, I would not make any effort to predict an outcome. The prospects at present are rather dismal. There needs to be movement on agriculture, non-agriculture market access, services and the development issues such as special and differential treatment for less developed countries and developing country preferences. The North–South divide, one of the legacies of the Uruguay Round, has been configured since Cancun by the New Geography. The two new coalitions – the G20 led by the Big Three (Brazil, India and China) and the G90, including the poorest developing countries, especially from Africa – have survived despite repeated efforts by the Big Two (the EU and US) to split or co-opt them.

It is difficult to evaluate the impact of the new geography on Doha. There does not appear to be any coherent strategy by either the G20 or the G90, except perhaps on agriculture. And the issue of special and differential treatment for less developed countries has split North and South, and South and South. So one real danger is that the new geography could result in transforming trade into a zero-sum game.

Could the Big Two pull off a Grand Bargain, as in the Uruguay Round? I doubt it – the Grand Bargain turned out to be a Bum Deal. Anyway, agriculture is no longer the only round-maker or -breaker.

By analogy with the assertion that trade is not the only avenue of regional integration because institutions matter, what about considering some structural reform proposals at the Hong Kong trade ministerial meeting? In addition to the suggestions from the Sutherland Advisory Group, there have been a large number of studies recently on basic concerns such as trade and development. There have also been studies on the interactions of regional and global trade agreements. What is to prevent the WTO and host government from launching some working groups – policy seminars – on these and other priority subjects? Perhaps one outcome could be to establish a policy forum in the WTO. There was such a forum in the GATT when the trading system was much simpler. And the Sutherland Group, as well as many others, recommended that one be established in the WTO.

Notes

1 Robert A. Pastor (2004) "North America's Second Decade," *Foreign Affairs*, January/February: 127.
2 Council on Foreign Relations (2005) *Building a North American Community*, Independent Task Force Report No. 53, Washington, DC, p. 14.
3 Sidney Weintraub (2005) "A North American 'Community': Pros and Cons," *Issues in International Political Economy*, January, Number 61, Washington, DC.
4 John Scott (2004) "Poverty and Inequality," in Sidney Weintraub (ed.), *Nafta's Impact on North America: The First Decade*. Washington, DC: Centre for Strategic and International Studies, pp. 307–337.

15 Interactions between regional and global trade agreements

Gary Clyde Hufbauer

Introduction

Others have had much to say about NAFTA and the FTAA. In this article, rather than the specifics of hemispheric trade, I examine three general aspects of interaction between regional and global trade agreements. The first, and most widely debated, is the extent to which regional trade agreements are undermining the global trading system. The second is changes that would help reassert WTO primacy as the negotiating forum for global commerce. The third concerns constructive steps that regional (and bilateral) trade pacts might take to buttress the global trading system.

Creative destruction or Gresham's Law?

In 1950, Jacob Viner posed the tension between regional agreements and the GATT: trade creation *versus* trade diversion.[1] In doing so, he spawned a truly vast literature.[2] Much later, in 1991, Jagdish Bhagwati suggested the metaphor of "building blocks" versus "stumbling blocks," and then in 1995 condemned the growing network of regional and bilateral agreements for their "spaghetti bowl" character.[3] In 1990, Ronald Wonnacott raised the specter of "hub-and-spoke" systems that would disadvantage the spokes.[4] Offering a riposte, in 1996, C. Fred Bergsten coined the phrase "competitive liberalization" – suggesting that free trade agreements could inspire one another, and the WTO as well, to knock down barriers at a faster pace.[5]

The virtues and vices of regional trade agreements have been so thoroughly debated that the arguments of an author can be anticipated by his choice of labels. Those who deplore less than multilateral trade agreements, led by Jagdish Bhagwati and Arvind Panagaryia, insist on the label Preferential Trade Agreements (PTAs). Those more favorably disposed, notably trade ministers and my colleagues at the Institute for International Economics, call them Free Trade Agreements (FTAs). In reality, of course, less-than-multilateral agreements are both preferential (and therefore discriminatory) and liberalizing (by removing barriers on regional commerce).

My take is to ask whether competition between regional arrangements and

the WTO represents a slow-motion process of creative destruction (as celebrated by Joseph Shumpeter) or instead an institutional example of Thomas Gresham's famous law (bad money drives out good).

Creation *versus* diversion

Before turning to Shumpeter versus Gresham, allow an obligatory detour to ponder Viner's old chestnut, trade diversion versus trade creation. General precepts have been formulated *ad nauseum* – having to do with the nature of goods traded, the competitiveness of the trading partners, the height of barriers, etc.[6] – but whether a given bilateral or regional agreement creates or diverts more trade is essentially an empirical question. The two modern "warhorses" of empirical analysis are computable general equilibrium (CGE) models and gravity models. Typically, they give very different answers.

A core feature of CGE models is the embedded array of Armington assumptions about the extent to which, for a given change in relative price, country A's merchandise delivered to the market of its FTA partner, country X, substitutes for (i.e. displaces) merchandise supplied by countries B, C, etc., by contrast with merchandise supplied by producers in country X itself. Rates of substitution are rarely estimated in a serious way. Rather they are imposed by modelers on the basis of fragmentary evidence. Obviously, if high rates of substitution are assumed between the merchandise of countries A, B, and C, and low rates of substitution are assumed between the merchandise of the FTA partners, the CGE model will predict a high ratio of trade diversion to trade creation when country A and country X enter into a free trade agreement. Conversely, if a high rate of substitution is assumed between the merchandise of the FTA partners, but not between the merchandise of countries A, B, and C, then the CGE will predict a low ratio of diversion to creation. The calculated balance between trade creation and trade diversion, in other words, says as much about the assumptions of the model as about the real world of free trade agreements.

A widely used data set for CGE models is the one provided by the Global Trade Analysis Project (GTAP). The most current version is GTAP6, which represents the global economy in 2001. In exercises for the Institute for International Economics, John Gilbert used GTAP6, and the GTAP modeling framework, to assess the effects of NAFTA and eight bilateral US FTAs recently negotiated or in the works.[7] To be clear, the GTAP modeling framework relies on "plain Jane" comparative statics, without increasing returns to scale, monopolistic competition, or induced innovation. Accordingly the estimated trade and welfare gains are at the low end of the range calculated by other CGE models.

The results of Gilbert's analysis of NAFTA are summarized in Table 15.1. Basically, his "naive" versions of the "plain Jane" CGE model – taking into account only tariff reform – predicted small declines in the total trade of Canada, Mexico, and the United States with their respective partners and with the world as a consequence of NAFTA. In other words, calculated trade diversion exceeds

trade creation. In fact, between 1997 and 2001 all three countries experienced a robust growth in trade, especially Mexico. The outcome largely reflected global economic expansion, and does not disprove the possibility that the NAFTA diverted more trade than it created. Not surprisingly, as Gilbert added other features to the "naive" CGE model – actual as opposed to predicted tariff reform, tax changes, factor accumulation and factor productivity – the model predictions came closer to the actual experience of NAFTA members between 1997 and 2001.

Comparable "naive" CGE predictions for the eight bilateral FTAs are reported in Table 15.2. In this panel, with the exception of Morocco and the South African Customs Union (SACU), trade creation is predicted to exceed trade diversion for all FTA partners. However, even on a bilateral basis, the predicted trade expansion is small, typically in the range of single-digit percentage gains.

By contrast with "plain Jane" CGE results, gravity model calculations suggest very substantial trade gains between FTA partners. Using databases assembled by Andrew Rose, Robert Feenstra, and Robert Lipsey, my colleague Dean DeRosa has estimated the impact of regional trade agreements (RTAs) and numerous other forces on bilateral trade flows, examining the entire period 1962–1999, and separately for the more recent periods 1990–1999 and 1995–1999.[8] DeRosa's coefficients, reported in Table 15.3, are similar to coefficients estimated by Rose and other analysts.[9] Of course just looking at trade between bilateral partners says nothing about trade diversion. However, according to the gravity model estimates, an FTA increased bilateral two-way trade between the partners by about 128 percent in the period 1995–1999. If an FTA more than doubles two-way trade between the partners, it is hard to believe that a greater amount of trade might have been diverted from other "outside" suppliers. In my view, the gravity model results – buttressed by later-generation CGE models (not reported here) – decisively answer the creation/diversion debate in favor of FTA trade creation.

Even so, using an analytic framework in the spirit of the gravity model, and a database that ends in 1997, authors at the Australia Productivity Commission (APC) claim that they find net trade diversion for twelve out of sixteen recent PTAs.[10] Their technique for measuring diversion is poorly explained in the paper. While I have a lot of respect for the APC authors, I do not believe the results reported in this paper. The Institute for International Economics may commission an in-depth analysis, and in this essay my reservations are confined to a footnote.[11]

Schumpeter *versus* Gresham[12]

The Sutherland Report, commissioned by Director General Supachai Panitchpakdi, had no doubt on this question.[13] Chapter II, largely authored by Jagdish Bhagwati, sees enormous damage from PTAs and very little benefit in return.[14] The burden of Chapter II is the erosion of the unconditional most-favored-nation (MFN) principle and resulting grief to the world trading system:[15]

Table 15.1 CGE estimated impact of NAFTA on member economy exports, 1997–2001

	Canadian exports				*US exports*			*Mexican exports*	
	Total	*US*	*Mexico*	*Total*	*Canada*	*Mexico*	*Total*	*Canada*	*US*
a Initial exports (1997)[1]	230,961	168,165	1,257	852,808	135,019	68,251	115,222	3,747	86,409
b Final exports (2001)[2]	250,580	187,165	2,630	830,114	134,767	84,243	154,379	5,195	121,748
c Percent change 1997–2001	8.5	11.3	109.2	–2.7	–0.2	23.4	34.0	38.6	40.9
d Naive CGE prediction	–5.5	–5.1	15.8	–6.2	–4.1	–2.9	–4.6	–4.1	–4.2
e Actual trade reform	–6.1	–5.8	25.8	–6.4	–5.5	–5.0	–5.3	–4.9	–5.0
f All tax adjustments	–5.4	–7.9	15.9	–5.2	–8.2	–4.2	–6.2	–6.2	–8.2
g f + Factor accumulation	0.2	–3.3	45.2	14.3	–2.7	26.1	34.4	27.0	32.1
h g + Factor productivity	5.1	8.4	68.4	2.7	3.5	55.8	38.2	33.0	42.5

Source: DeRosa, Dean and John Gilbert (2005) "Predicting Trade Expansion under FTAs and Multilateral Agreements," paper presented for The Institute for International Economics, Washington, DC (www.petersoninstitute.org/publications/wp/wp05-13.pdf).

Notes
1 US$ 1997 millions. Source: GTAP5.4 Database.
2 US$ 1997 millions. Source: GTAP6 Database.

Table 15.2 CGE estimated impact of US free trade agreements on partner country imports and exports[a] (percent change)

	United States	*Switzerland*[b]	*Chile*	*Australia*	*Singapore*	*Morocco*	*CAFTA*	*SACU*[b]	*Thailand*[b]
Import value	0.8	1.8	2.8	1.6	1.4	9.4	11.3	7.4	3.1
From partner/s	38.6	31.7	36.8	17.9	1.9	143.6	53.3	48.7	53.2
From ROW	–1.3	–2.1	–4.7	–2.1	1.3	0.1	–1.9	3.9	–2.6
Export value	1.7	1.0	1.5	0.7	2.3	–3.5	7.7	–1.6	1.1
To partner/s	27.3	12.1	9.7	14.5	9.2	12.6	41.4	65.1	22.0
To ROW	–0.4	–0.8	–0.4	–1.1	0.9	–5.3	–14.0	–7.9	–4.6

Source: Hufbauer, Gary Clyde and Richard E. Baldwin (2006) "The Shape of a Swiss–US Free Trade Agreement," Washington, DC: Institute for International Economics, *Policy Analyses in International Economics*, 76 (February).

Notes

a For the United States, the reported figures refer to the combined effect of FTAs with all the listed partners (prior FTAs with Israel, Canada and Mexico are not reflected in these calculations). For the other partners, the reported figures refer just to an FTA with the United States.

b FTAs under consideration.

Table 15.3 Gravity model estimates for total trade, 1962–1999[a]

Variable	*Representation of variable*	*All commodities and manufactures (SITC 0 through 9)*		
		1962–1999	*1990–1999*	*1995–1999*
Constant		–19.27***	–7.00***	–6.93***
Distance	Log	–0.79***	–0.77***	–0.72***
Joint GDP	Log	0.75***	0.53***	0.53***
Joint GDP per capita	Log	–0.10***	–0.25***	–0.28***
Common language	Dummy	0.20***	0.19***	0.22***
Common border	Dummy	0.55***	0.96***	0.91***
Landlocked	Dummy	–0.19***	–0.50***	–0.53***
Island	Dummy	0.11***	0.34***	0.31***
Land area	Log	–0.13***	–0.07***	–0.06***
Common colonizer	Dummy	–0.06**	–0.15***	–0.11**
Colony	Dummy	0.75***	0.30*	0.29
Ever a colony	Dummy	1.67***	1.00***	0.95***
Common country	Dummy	0.22	–0.65	–0.67
Currency union	Dummy	0.80***	1.52***	1.40***
GSP	Dummy	–0.14***	0.33***	0.28***
RTAs[c]	Dummy	0.33***	0.32***	1.19***
R-sq		0.40	0.34	0.36
Obs. (thousands)		940	263	146
Groups (thousands)		61	44	41

Source: Hufbauer, Gary Clyde and Richard E. Baldwin (2006) "The Shape of a Swiss–US Free Trade Agreement," Washington, DC: Institute for International Economics, *Policy Analyses in International Economics*, 76 (February).

Notes

a The dependent variable is log real trade. Distance, GDP, GDP per capita and land area are measured in log terms. Estimate year effects are not reported. ***, **, * indicate that the coefficients are statistically significant at the 99 percent, 95 percent, and 90 percent levels, respectively. Groups are numbers of country-pair-commodity combinations for which trade exists in the data sample.

b Logarithmic (log) variables are represented by the exponent of the natural number e. Dummy variables are represented by 0 or 1. Coefficients for the logarithmic variables can be interpreted as elasticities. For example, in the period 1995–1999, a 10 percent increase in distance between two countries decreased the volume of two-way trade by 7.2 percent. Since this model uses a log-linear specification, coefficients for the dummy variables can be interpreted as shift coefficients. For example, in the period 1995–1999, membership in one of the ten RTAs would augment the volume of two-way trade by a factor of 2.28 (an increase of 128 percent), which equals the value of the natural number e raised to the power 1.19.

c The regional trade agreements covered by the RTA variable are: Association of Southeast Asian Nations (ASEAN), European Union (EU), US–Israel FTA, North America Free Trade Agreement (NAFTA), Caribbean Community (CARICOM), Agreement on Trade and Commercial Relations between the Government of Australia and the Government of Papua New Guinea (PATCRA), Australia–New Zealand Closer Economic Relations Trade Agreement (ANZCERTA), Central American Common Market (CACM), South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA), and the Common Market of the South (MERCOSUR).

> Yet nearly five decades after the founding of the GATT, MFN is no longer the rule; it is almost the exception. Certainly, much trade between the major economies is still conducted on an MFN basis. However, what has been termed the "spaghetti bowl" of customs unions, free trade areas, preferences and an endless assortment of miscellaneous trade deals has almost reached the point where MFN treatment is exceptional treatment. Certainly the term might now be better defined as LFN, Least-Favoured-Nation treatment. Does is matter? We believe it matters profoundly to the future of the WTO…

Customs unions, free trade areas, and an endless assortment of miscellaneous trade deals are encroaching on the policy space once reserved for the GATT. Put in the vernacular, PTAs are eating the WTO's lunch. By the Sutherland Report's count, 150 PTAs are already in force, and the number threatens to rise to 300 based on notifications so far made. Indeed, since the birth of the WTO in January 1995, some 176 PTAs have been notified. This short history calls to mind Goths encroaching on the Roman Empire.

What are the reasons for the ascendancy of PTAs, the relative decline of the WTO, and the concomitant rise of "Least-Favoured-Nation treatment"? The Report notes weaknesses in the defensive armory of the old GATT, essentially repeated in the new WTO, for example Article VI which permits discriminatory anti-dumping and countervailing duties and the Enabling Clause which enshrined "Special and Differential Treatment" for developing countries.

But the real culprit, in the eyes of the Report, is the proliferation of PTAs that fall well short of Article XXIV standards, and the signal failure of the GATT/WTO system to repulse these invaders. The Report greets with skepticism arguments that PTAs are a "building block" for future WTO agreements, or that the spirit of "competitive liberalization" accelerates the pace of ongoing WTO talks.

Creative destruction

Judging from the slow pace of the Doha Round, and the looming failure of the Hong Kong Ministerial Conference, even while new FTAs are concluded almost monthly, it is hard to argue that competitive liberalization has *recently* been a force for global liberalization *under WTO auspices*.[16]

On the other hand, new FTAs have inspired each other – as the headcount shows – most recently in Asia. Institutional creative destruction is at work. Fresh liberalization, aimed at zero tariffs on manufactured goods, and reduced barriers on agriculture and services, along with frontier subjects like technical standards, has become the province of regional and bilateral free trade agreements. The WTO is simply not able to deliver large dollops of new liberalization, however successful it may be in resolving disputes between members. Achieving consensus on a broad package among 150 members – when there are ten to thirty holdouts on any given controversial issue – is proving too difficult, especially on "sensitive" subjects like agriculture and services.

Drawn out negotiations, with no definite promise of meaningful trade liberalization, simply cannot hold the attention of business leaders, the core constituency of the world trading system.[17] Nor are long negotiations the stuff for the best and brightest government bureaucrats to advance their careers. By contrast, FTAs are often concluded in five years or less, and the better FTAs even eliminate tariffs on manufactures trade (a distant goal for the WTO), and some FTAs even promise to phase-out agricultural barriers (a goal beyond the horizon for the WTO). The complex network of FTAs is surely messy and discriminatory – just like the jostling that takes place in every competitive market. FTAs are surely not the high road to a world of freer trade. For now, however, they offer the open road.

Reasserting WTO primacy

What can the WTO do to reassert its primacy as the high road to freer trade? Among its remedies, the Sutherland Report recommends that *developed* members should establish a date certain for zero tariffs. Why just *developed* members? Why not all members? As amply documented in numerous studies,[18] free trade is a better remedy for national poverty than protection. The Report's lapse from good economics can be explained by political correctness: everyone "knows" that trade ministers representing poor countries cannot be asked to dismantle their protective barriers because … well, because they like to use muddled infant industry arguments to confer favors on well-connected constituents.

In the nature of the Sutherland Report, perhaps good economics was dispensable, but good political economy was not. The WTO will not thrive as a negotiating forum if it slides into the space once occupied by UNCTAD and the G-77: a forum for beating up on OECD nations, demanding one-way free trade and kindred concessions.

In political economy terms, all developing WTO members with commercially interesting markets – defined, for example, by threshold gross national income of $200 billion (measured in PPP terms) – should join the game of mercantilist reciprocity if zero tariffs by a date certain are to become a reality. This threshold would encompass Argentina, Bangladesh, Brazil, China, Colombia, Egypt, India, Indonesia, Malaysia, Pakistan, the Philippines, South Africa, Taiwan, Thailand, and Turkey – plus the Russian Federation, Ukraine, and Saudi Arabia, when they join the WTO. In 2000, these developing countries accounted for 17 percent of world merchandise exports and 14 percent of world merchandise imports, shares that will grow in the decades ahead. It is not realistic to ask the United States, the European Union, Japan, Korea, and other OECD members to cut their tariffs to zero, agricultural and industrial products alike, if commercially important developing countries will not subscribe to the same agenda.

One avenue of counterattack on the "PTA curse" would entail a carefully aimed case brought to the dispute settlement system. Hong Kong, for example, might bring a case against the Singapore–Japan PTA, arguing that the total

exclusion of agriculture is not compatible with Article XXIV. If Singapore and Japan lost in the Appellate Body, they might be required to open their service and industrial markets on an MFN basis to all WTO Members, a relatively mild penalty – and an excellent example for other PTAs.

Besides these immediate remedies, the WTO needs to recognize that its failure as a negotiating hall stems in large part from its unflagging allegiance to the consensus principle and its hostility to plurilateral agreements.

What does "consensus" mean? The term was not defined in the GATT-1947. Unfortunately, footnote 1 to Article IX of the Marrakesh Agreement interpreted "consensus" rigidly, giving it the flavor of an "obstruction principle": "The body concerned shall be deemed to have decided by consensus on a matter submitted for its consideration, if no Member, present at the meeting when the decision is taken, formally objects to the proposed decision." When a consensus cannot be reached, Article IX provides an alternative: decision by majority voting, on a one member, one vote principle.[19] This alternative, however, is theoretical not practical. Voting almost never took place under the GATT-1947. On a contested matter, it would be absurd for Iceland, with imports of around $2 billion annually, to have the same weight as Germany, with imports of around $500 billion.

As a practical matter, therefore, consensus is the decision-making principle in the WTO. With 150 members, and the prospect of 170, unless the consensus principle is surgically converted into a weighted voting formula, the WTO's arteries will harden to the point where the institution's life blood – namely successful negotiations designed to liberalize trade and write new rules – will cease to flow.

The problem is not just the determined opposition of one or two members. Obstruction is even more serious when a sizable number of members, even as many as thirty, that collectively represent less than 10 percent of world trade, insist on their way or the highway. this might happen, even in the Doha round, if members that benefit from non-reciprocal preferences, such as the Caribbean Basin Initiative countries (which benefit from one-way preferences into the US market), or the Africa, Caribbean, and Pacific countries (which benefit from one-way preferences into the EU market), come to view multilateral liberalization as hostile to their preferential arrangements.

Latent voting power (reflected in quotas) determines policies in the World Bank and the IMF. No parliament or congress operates by consensus. Even in the UN Security Council, the only consensus required is among the five permanent members.

Despite these obvious features about institutions that actually make decisions, and despite the many good suggestions that have been tabled for the WTO,[20] it appears that the organization would rather sink to irrelevance than reform its decision-making process.

If the consensus principle is to be sacrosanct, then the WTO has one remaining lifeline – more tolerance for plurilateral agreements. The Sutherland Report sternly warns against this sin:

> 297. Certainly the plurilateral approach would enable sets of WTO Members wishing to negotiate more ambitious commitments to do so. Groups might negotiate across a broad agenda or on single topics. What about the remaining Members? One proposal would permit them to participate in the negotiations of a plurilateral agreement but to retain the freedom to opt out of a result they found unpalatable. Another approach would be to exclude them from the negotiations but provide an opportunity for them to opt in at a later stage.
>
> 298. Clearly, this is a divisive approach that would enshrine a multiclass membership structure. It could take the multilateral trading system backwards rather than forwards…

Such pronouncements ignore a fundamental proposition about human nature: when an organization prevents consenting adults from enjoying each other's company in one social setting, they will find another.[21]

Constructive action by FTAs

New free trade arrangements, including the FTAA, new Asian FTAs, and new US FTAs, should incorporate three provisions that would improve the workings of the global trading system and reduce frictions with "outsiders." These same provisions should be included, retrospectively, in existing bilateral and regional agreements, including, foremost, the European Union, NAFTA, MERCOSUR, and the Australia–New Zealand CER.

Consistency with Article 24

The biggest contribution that each new FTA could make to the global trading system is advance agreement that the terms will be reviewed by the WTO, both for consistency with the standards of GATT Article 24, and to recommend compensation for "outsiders" that incur an erosion of the concessions agreed in prior WTO negotiating rounds as a consequence of the new FTA.

It is well known that GATT Article 24 has been widely disregarded by the vast majority of regional and bilateral trade agreements negotiated in the past two decades. The standard of Article 24 requires that "substantially all" trade become free of barriers. The basic idea is that governments should no more hamper commerce within an FTA than, for example, commerce between the provinces of Canada or the states of Mexico. In only one Article 24 review, however, has the WTO party reached a consensus that the FTA met the standards of Article 24. The basic problem, of course, is that the reviewers represent member governments, and each member government, during the course of review, is looking over its shoulder for adverse implications for its own FTAs.

One solution is for the Secretary General to appoint an independent standing

committee (staffed by the Rules Division of the WTO) that would review consenting FTAs and make appropriate recommendations. For reasons of judicial economy, the same committee should hear the evidence from the parties and recommend appropriate compensation. In past episodes, compensation agreements have often been reached only in the context of multilateral trade agreements (notably the Tokyo and Uruguay Rounds). In the future, compensation should become a normal feature of FTA packages.

After the system has been tested on new FTAs, existing pacts should agree to the same review. This will have to be done in a balanced fashion, so that WTO members do not see themselves solely in the victim or beneficiary camp. For example, NAFTA and MERCOSUR plus Brazilian FTAs in Latin America might agree to simultaneous reviews.

Dispute settlement

When parties to an FTA or regional trade agreement can have recourse to the WTO Dispute Settlement Mechanism (DSM) to resolve their differences, they should make the DSM the *sole* arbitrator, whether the arbitration is concluded under the substantive rules of the FTA or the substantive rules of the WTO. This provision would not apply to disputes between EU members, since those disputes are exclusively the province of the European Commission and the European Court of Justice. However, it should apply to disputes between NAFTA members, thereby eliminating the complex and costly forum shopping that has characterized, for example, the long-running softwood lumber dispute. Likewise, it should apply to other FTAs that envisage arbitration mechanisms.

This sensible change will draw on a strength of the World Trade Organization, namely a Dispute Settlement Mechanism that draws upon expert panelists in the first instance, and the Appellate Body for final review. It will shorten and simplify adjudication, harmonize legal procedures, and over time encourage FTAs to adopt the same substantive rules as the WTO.[22]

Rules of origin

A third constructive change that FTAs could make is to adopt highly flexible rules of origin. Forward-looking FTAs should accommodate, and indeed encourage, integration of the world economy, in which slices of the value added chain are performed in different countries. This goal can be accomplished by liberal interpretation of the "substantial transformation" principle. The rules should avoid stringent change-of-tariff-heading rules; they should encourage "cumulation" and allow remanufactures. The least burdensome certification method should be adopted.

Substantial transformation

Substantial transformation can be achieved by a change in the tariff classification between inputs from a third country and the exported product, resulting from activity in the territory of the FTA exporter. Depending on the product, that requirement could correspond to a change involving different Harmonized System (HS) chapters at the four-digit or six-digit heading level. Obviously, the less stringent test (change at the six-digit heading) is more favorable to world commerce.

An alternative requirement, which is sometimes combined with the change-of-tariff-heading rule, is a minimum share of local value added in the FOB value of the product. Typically, the minimum local content is 35 percent using the "build-up" method and 45 percent using the "build-down" method.[23] Lower thresholds would be better.

Cumulation

The cumulation issue centers on the designation of countries whose products qualify for meeting the rules of origin set forth in the free trade agreement. Will only goods manufactured in the two partner countries qualify? Or will goods manufactured in third-country FTA partners also quality? The answer is critical in a world where the components from several countries are assembled to make many final products, such as shoes, clothing, or computers.

Under the EU model (also adopted by EFTA), rules of origin permit goods from a number of countries that are linked by trade agreements with identical rules of origin to qualify, and the result is called "diagonal cumulation." This approach should be the goal of future FTA agreements, including the FTAA. By contrast, as normal practice, the United States has adopted a "bilateral cumulation" approach in its FTAs, meaning that only products manufactured in the partner country, whether sold as final goods or as inputs, qualify for meeting the rules of origin. Following a "bilateral cumulation" rule, inputs made in Chile, Singapore, or Australia – all countries with which the United States has negotiated FTAs – would not qualify if they were embedded as components of a Canadian product shipped to the United States.

Remanufactures

Remanufactures are industrial products assembled from "recovered goods." Remanufactured products are typically made from items listed in HS chapters 84, 85 and 87. The parts resulting from the disassembly of a product do not constitute a "recovered good" unless they are cleaned, inspected, and tested. In the production of a remanufactured good, the parts must be subjected to welding, flame spraying, surface machining, knurling, plating, sleeving, or rewinding. The United States contends that remanufactured products should qualify under the rules of origin, regardless of their original source. The US auto industry is particularly interested in this provision.

Certification

Switzerland has adopted procedures for the certification of origin that are significantly different from those adopted by the United States. While US bilateral FTAs establish declaration of origin by the importer, Switzerland requires certification by the exporter. Certification by the exporter is less cumbersome, as it puts the burden on the party with better information.

Notes

1 Jacob Viner, The Customs Union Issue, New York: Carnegie Endowment for International Peace, 1950.
2 My personal library devotes more than 30 feet of shelf space to books and articles that examine bilateral, regional, and multilateral trade arrangements.
3 Jagdish Bhagwati (1991) *The World Trading System at Risk*, Princeton, NJ: Princeton University Press; Jagdish Bhagwati (1995) "US Trade Policy: The Infatuation with Free Trade Areas," in J. Bhagwati and A. Krueger, eds, *The Dangerous Drift to Preferential Trade Agreements*. Washington, DC: American Enterprise Institute.
4 Ronald J. Wonnacott (1990) *U.S. Hub-and-Spoke Bilaterals and the Multilateral Trading System*, Toronto: CD Howe Institute.
5 C. Fred Bergsten (1996) "Competitive Liberalization and Global Free Trade," APEC Working Paper No. 96–15, Washington, DC: Institute for International Economics. The concept, but not the phrase, was anticipated in Gary Clyde Hufbauer (1989) *The Free Trade Debate*, Report of the Twentieth Century Fund Task Force on the Future of American Trade Policy, New York: Priority Press.
6 The pioneering taxonomy was formulated by James Meade (1955) *The Theory of Customs Unions*, Amsterdam: North-Holland Publishing Company.
7 The NAFTA analysis appears in Dean DeRosa and John Gilbert (2005) "The Economic Impacts of Multilateral and Regional Trade Agreements in Quantitative Economic Models: An Ex Post Evaluation," Washington, DC: Institute for International Economics. The eight bilateral FTAs are examined in Chapter 8, "Estimates from Gravity and CGE Models" (authored by Dean DeRosa and John Gilbert) in Gary Hufbauer and Richard Baldwin (2005) *The Shape of a Free Trade Agreement between Switzerland and the United States*, Washington, DC: Institute for International Economics.
8 The results appear in Chapter 8, "Estimates from Gravity and CGE Models" (authored by Dean DeRosa and John Gilbert) in Gary Hufbauer and Richard Baldwin (2005) *The Shape of a Free Trade Agreement between Switzerland and the United States*, Washington, DC: Institute for International Economics. DeRosa examined trade in one-digit SITC categories as well as total bilateral trade. Only the totals are reported in Table 15.3 of this paper. However the one-digit SITC coefficients for the RTA variable follow the same pattern – they are statistically significant, and they grow stronger in later periods.
9 See, for example, Andrew K. Rose (2004) "Do we really know that the WTO increases trade?" *American Economic Review*, 94(1).
10 Richard Adams, Philippa Dee, Jyothi Gali and Greg McGuire (2003) "The Trade and Investment Effects of Preferential Trading Arrangements – Old and New Evidence," Staff Working Paper, Canberra: Australia Productivity Commission, May. The twelve PTAs for which the authors claim net trade diversion (see their Table 4.3) include: AFTA, EFTA, EC/EU, MERCOSUR, NAFTA, CER, EU–Switzerland, Chile–Colombia, Australia–PNG, Chile–MERCOSUR, EU–Egypt, and EU–Poland. The four PTAs for which the authors claim net trade creation are: Andean Pact, LAFTA/LAIA, US–Israel, and SPARTECA.

11 The APC authors add up their three FTA coefficients in a different manner (and often get a different sign) than the methodological predecessor paper authored by I. Soloaga and L.A. Winters (2001) “Regionalism in the nineties: what effect on trade?” *North American Journal of Economics and Finance*, 12(1). Nowhere in the APC paper is there a simple table, comparable to Table 15.2 of this paper, showing the amount of trade created between PTA members and diverted from non-members. Instead of deleting zero-trade observations from the database (the customary procedure), the authors represent them in a curious manner in the regression analysis, which biases the estimated coefficients. The text description of the variables does not match up easily with the tables. The specification of the “dynamic” gravity model – just adding a time dimension to annual observations – seems peculiar. As we examine the APC paper, other difficulties may come to light.

12 This section draws heavily from my commentary, Gary Clyde Hufbauer (2005) “Inconsistency between Diagnosis and Treatment,” *Journal of International Economic Law*, 8(2).

13 Peter Sutherland (2004) *The Future of the WTO: Addressing Institutional Challenges in the New Millennium*, Report by the Consultative Board to the Director-General Supachai Panitchpakdi, Geneva: World Trade Organization. The members of the Consultative Board were Peter Sutherland (Chairman), Jagdish Bhagwati, Kwesi Botchwey, Niall FitzGerald, Koichi Hamada, John H. Jackson, Celso Lafer, and Thierry de Montbrial.

14 Making sure no one missed the point, Bhagwati penned an op-ed, “The Truth About Trade,” for the *Wall Street Journal*, 18 January 2005, p. A16, excoriating preferential trade agreements in even stronger terms than Chapter II.

15 Sutherland Report, p. 19.

16 The force of competitive liberalization – specifically the conclusion of NAFTA and the seeming ascent of APEC in the mid-1990s – played a significant role in persuading the European Union to wrap up the Uruguay Round.

17 J. Michael Finger (2005) “The Future of the World Trade Organization: Addressing Institutional Challenges in the New Millennium – A review,” *Journal of World Trade*, 39(4).

18 See, for example, William R. Cline (2004) *Trade Policy and Global Poverty*, Washington, DC: Institute for International Economics.

19 Decisions on waivers and amendments require supermajorities, spelled out in Article IX.

20 See, for example, Jeffrey J. Schott and Jayashree Watal (2000) “Decision-Making in the WTO,” Institute for International Economics, *Policy Brief 00–2*, March; and John H. Jackson (2001) “The WTO ‘Constitution’ and Proposed Reforms: Seven Mantras Revisited,” *Journal of International Economic Law*, 4(1), March.

21 Moreover, the lead sentence in paragraph 298 ignores an important lesson from the Tokyo and Uruguay Rounds: that a “multiclass structure” need not be permanent. By and large, the Tokyo Round codes came to be accepted in the Uruguay Round by all WTO Members.

22 Alternatively, when multiple FTAs adopt a different substantive rule, the WTO may modify its own standard.

23 The “build-down” method estimates the share of the local value added in the FOB price by subtracting overhead, transportation, and similar costs. The “build-up” method estimates the share of local value added by combining the cost of originating materials used in making the final product. The US–Australia FTA uses a variant, a net cost method, for certain automotive products.

16 Cleaning up the spaghetti bowl

John M. Curtis

These observations on regionalism and multilateralism are made in a personal capacity and from the perspective of an economist. For this I ask your forbearance. The news from the world of trade policy these days is often depressing enough without having someone from the dismal science weighing in. However, having made it my mission in life to establish a professional Office of Economics in Canada's international trade department, something which was formally confirmed some months ago with the establishment of the Office of the Chief Economist, I feel a burden of responsibility to bring economics into the discussion of current trade policy issues.

About the spaghetti bowl

Preferential trade agreements, as is well known, were provided for in the original GATT treaty in 1947. They have since become a well-established fact of life, with the handful of largest agreements alone covering some two-fifths of global merchandise trade. They establish trade preferences amongst a handful of economies that are only pale imitations of the preferences that have long existed within federations such as the United States or Canada. They have been studied, if not to death, at least to the exhaustion of the would-be student thereof. The circumstances under which they may be legitimately established have been litigated at the WTO to protect third parties from being sideswiped.[1] I strongly suspect there is nothing particularly new or profound that could be said about this. What, then, is it about them that puts a gleam in the eye of trade negotiators, stirs up controversy amongst commentators, and even evokes fear and loathing in the hallways of the WTO? In a word, it is discrimination.

Unlike Groucho Marx, who, as you might remember, claimed to be disinclined to join any club that would have him as a member, economies are attracted to exclusive trade agreements like celebrities to an A list. There is something of the elixir of the illicit in these agreements: getting a special deal, stealing a march on your competitors, eating someone else's lunch, basking in the glow of being invited to a negotiation, or securing one's own market access while others flounder in an uncertain world. And of course, it is not enough to

have won, it adds spice that somebody else feels they have lost and sits waiting on a B list – for that is what competitive discrimination means.

But what is attractive to governments, their trade negotiators, and sundry others (including political scientists, political economists, not to mention media gurus) is controversial to economists. Some economists run their models to determine whether trade creation tops trade diversion, usually find that it does, and then ask, what is the fuss? Others look for the inherent evils that must accompany discrimination and have no difficulty finding them – incentives to buy from less efficient producers which create vested interests that then militate against further liberalization, a deadweight cost of administering the agreements, and so forth. Some see the proliferation of such agreements creating a tangled mess of inconsistent overlapping rules – the proverbial spaghetti bowl. Others see a dynamic that, once unleashed, can lead to only one possible equilibrium – global free trade (by some strange alchemy, enough discrimination results in no discrimination!) The debate rages.

And the friends of the multilateral system – and some of those who administer it – fret about the systemic implications. Of greatest concern to them is the erosion of the foundational principle of the GATT and its successor, the WTO: the amount of trade conducted under the non-discriminatory most-favoured-nation (MFN) principle is shrinking. In some cases, MFN is now better described as LFN: least-favoured-nation, as most trading partners have some sort of preference. And that is on top of the diversion of scarce negotiating resources away from the slow-moving, highly complex Doha Round and the expenditure on minor agreements of even scarcer political capital that might more profitably have been used to clinch an ambitious multilateral deal.

The only tenable conclusion is that preferential trade agreements are a qualified good that carry sufficiently high risk to warrant attention. Cleaning up the spaghetti bowl is a worthwhile endeavour. Secondly, since moving backward is impractical, the only way to clean up the spaghetti bowl is to move forward by widening and consolidating the existing regional trade agreements (RTAs). And there is no better place to start than the Americas, where existing regional agreements are losing credibility, where new ones are proliferating, and where the visionary Free Trade Area for the Americas that could rationalize trade rules in the hemisphere is stalled. Thirdly, the essential complementary requirement is an ambitious outcome to the current Dohu Round of multilateral trade negotiations. And this for several reasons: to minimize the distortions created by discriminatory preferential agreements, to provide some centrifugal force to counter the centripetal forces of regionalism, and to deal with the difficult institutional aspects of trade that preferential agreements have proved generally incapable of adequately addressing.

Cleaning up the spaghetti bowl is worthwhile

The broad empirical consensus that preferential trade agreements have tended to create more trade than they have diverted is the main analytical pillar of support

for such agreements. Yet this empirical consensus is based on a specific set of agreements that were put in place in a specific global context. This includes first the European Union, which Anne Kreuger described as "the sole meaningful exception to the proposition that the global trade regime had become increasingly multilateral under GATT, had experienced growth in its trade with its non-EU trading partners at a rate not only above its own rate of growth but also above the average rate of growth of trade for all countries."[2] And second, it includes NAFTA and its precursor, the Canada–US FTA, which was part of the building wave of preferential agreements in the 1980s. There is no guarantee that this result will hold for the smaller agreements currently being negotiated or that might be negotiated in the future.

There are several grounds for this concern. First, it might be observed that the initial price effect of preferential agreements on third parties must necessarily be diversionary; it is only the second-round income effects generated by the hopefully positive impact of the preferential agreement on growth in the partner economies that can generate the offsetting increase in demand for third-party products that allows the preferential agreement to be overall welfare-enhancing.

In this regard, the economic geography literature has provided persuasive evidence that proximity matters to trade – trade between immediate neighbours accounts for a disproportionately large share of global trade. The major preferential trade agreements were put in place by immediate neighbours – hence the tendency to label them regional trade agreements – where the growth impact of liberalization was potentially the strongest. It is unclear whether this same conclusion will ultimately hold for the rash of preferential trade agreements between distant trading partners which have much less power to leverage increases in trade and still less in growth.

This concern is reinforced by consideration of analysis of the impacts of trade liberalization at the firm level, where trade actually takes place. John Baldwin, head of the Microeconomic Analysis group at Statistics Canada, has traced the growth in productivity and innovation of firms that became exporters versus those that did not. He found that entering export markets had a powerful stimulative effect on both innovation and productivity growth; by contrast, firms that did not enter export markets and find their way into global supply chains tended to wither. Earlier work by Caroline Freund suggested that an important effect of free trade agreements was the inducement to firms to accept the initial sunk costs of establishing a presence in an export market, based on assurance of market access. This has sometimes been called the "animal spirits" effect of free trade agreements. Taken together, these results suggest that the growth-enhancing effect of free trade agreements derives in large measure from the microeconomic effect on firm level export behaviour.

There can be no doubting that animal spirits in Canada were roused by the Canada–US FTA and by the NAFTA – in the latter case, anecdotes abound of the rapidity with which Canadian businesses moved to seize trade opportunities with Mexico. But I suspect that one would be hard pressed to find similar animal spirits effects in reaction to the flurry of smaller FTAs. Indeed, business reaction

is often at best a yawn and at worst outright criticism – and this even ignoring the predictable defensive outcries from those vested interests that stand to lose from liberalization.

At the same time, there is little reason to doubt the potency of preferences to divert trade. From the general equilibrium modelling work, there is a stylized fact that the elasticity of substitution across alternative import sources is double the elasticity of substitution between domestic and foreign sources. In short, there is no assurance that the empirical consensus that trade created by preferential agreements tends to dominate trade diverted has any generality at all.

A second, straightforward reason to "clean up the spaghetti bowl" is to reduce the deadweight administrative costs of overlapping and inconsistent agreements. The costs of compliance with rules of origin certification are not trivial; there is anecdotal evidence that in some cases firms will pay the MFN tariff rather than expend the effort required to generate the necessary certification.

The only feasible way is forward: by consolidating and expanding existing agreements

If one accepts the game theoretic conclusion that once the move to preferential trade agreements gets underway the incentives lead all economies to join the dance, the only possible outcomes are proliferation or consolidation. Political considerations lead to exactly the same conclusion.

The WTO currently has 151 members with some thirty observers either negotiating accession or preparing to start accession negotiations. Amongst these economies alone, there are more than 15,000 bilateral trading relationships. Consolidating the twenty-seven-member European Union into one trading entity reduces the number of bilateral relationships to a little over 11,000. This puts in stark relief the potential complexity of proliferation and the efficiency gains from consolidation.

These theoretical limits would of course never be approached. Even so, the point remains. For example, there are presently some twenty-five preferential agreements involving Asia-Pacific economies in force, under negotiation or under study that could potentially be subsumed by one over-arching FTA of sixteen Asia-Pacific economies that has been proposed. And that ignores the number of FTAs that might be prompted within this group in defensive response to the agreements already in place or in progress. A similar degree of consolidation could be achieved through an ambitious FTAA in the Americas, where some twenty agreements are already notified at the WTO and more are under negotiation.

The reduction in negotiating and administrative costs from such consolidation would be large, especially when the opportunity costs of diverting negotiators from the multilateral talks are taken into account. Even more importantly, such consolidation would seem to have the power to arouse animal spirits and to unleash the dynamic gains from trade liberalization that underpin the welfare-

enhancing reputation of preferential trade agreements. By the same token, they might attract sufficient support of business to make them attractive enough in political calculations to warrant the expenditure of political capital necessary for their realization.

When something needs doing, it is always good to start at home. We in the Americas have a first-rate opportunity to help begin the process of consolidating trade agreements by breathing new life into the moribund Free Trade Area of the Americas negotiations. If a spur is needed to galvanize the expenditure of political capital to that purpose, we need look no further than the proposed Asia-Pacific grouping. A trading bloc from Mumbai to Christchurch and reaching north to Tokyo, Beijing, and Seoul should provide similar motivation to the Americas in this era of globalization that Jacques Delors' Single Market exercise provided for North American economic integration in context of what was then still a predominantly North Atlantic trading system. If nothing else, fear might well accomplish what greed apparently has failed to do.

But regionalism is not sufficient: the importance of multilateralism

If regionalism cannot be ignored, neither can the multilateral process. Multilateral tariff reductions squeeze the margins of preference accorded by preferential trade agreements, and thus improve the welfare gains from such agreements by reducing the negative trade-diversionary effects while leaving the trade-creating effects in place.

Moreover, as is well known to trade policy experts, some subjects are simply too large to paint on a regional canvas; nothing short of a global agreement will do the trick. Agriculture is one of those issues; government procurement is another. Increasingly, the trade-off between services liberalization and market access is also becoming possible only on a global scale, given the contrasting areas where economies around the world have something of value to offer their negotiating partners. And the important issues of the global political economy – in particular, the disciplining of trade remedies – also appear to require the weight of a WTO agreement. Indeed, in light of the US decision not to comply with the NAFTA panel decision on softwood lumber, it would be surprising if any breakthrough on rules will be achieved in any forum other than the WTO, except perhaps in minor agreements where it would not matter in the first place.

Recently, Brazil's Foreign Minister Celso Amorim suggested that the Doha Round and the FTAA could not both be pushed along at the same time; Brazil, he said, had to make a choice and its choice was the Doha Round. Of course, with trade negotiators one is never quite sure whether a statement is tactical. One can hope that is the case in this instance and that a fresh perspective on the importance of combining large scale regionalism with the multilateral process will give fresh impetus to both.

Notes

1 In its decision on Turkey – Restrictions On Imports Of Textile And Clothing Products (*Turkey – Textiles*), the WTO recommended that Turkey remove certain quantitative restrictions it imposed on textiles from India as part of its entry into a customs union with the European Union in 1995. The WTO Appellate Body upheld the Panel decision that there were alternatives available to Turkey and the European Communities to prevent any possible diversion of trade, while at the same time meeting the requirements of Article XXIV.

2 Anne O. Krueger (1999) “Trade Creation And Trade Diversion Under NAFTA”, NBER Working Paper 7429, December, p. 1.

17 Isolation, intervention, and exchange rights

Principles in trade theory

Earl L. Grinols

Introduction

The years after World War II are remarkable for a number of changes, not least of which is the tremendous expansion of world trade, the continuing positive effect of the General Agreement on Tariffs and Trade and, since 1995, the World Trade Organization.[1] Much of the activity in the political sphere relates to a substantial increase in the number of preferential trading areas.[2]

In addition to advances in practice, the post-World War II era has also been productive of advances in international trade theory. Questions that were not previously answerable are now well understood, and answers can be provided that are based on intrinsic features of markets and economies. In some cases what has been learned might better be termed "discoveries," because it provides uniquely correct answers to well-defined problems. This chapter discusses one such avenue of advancement. It is an area of international trade theory within which I have had special interest, but, more importantly, can make claim to special status. Many researchers have hoped for a way to implement efficiency-generating changes to an economy, at the same time spreading the gains broadly and smoothly enough that every agent is strictly better off in the post-change circumstances or, at worst, indifferent to his or her original position. The importance of such knowledge barely needs stating: if efficiency gains can be spread, then a path from a Pareto inferior equilibrium to a Pareto superior one can be found that has strong claim to support from every agent, or at least little reason for opposition. By piecing together a series of such steps, one could move stepwise to a Pareto optimal position, harming no-one in the process. Finding the way to construct one "step" is key to the rest. Because international trade is focused on the benefits of trade, removal of the impediments to which leads to gains from trade, it is the field of general equilibrium theory that has been most interested in spreading the gains to avoid losers.

I will explain in what follows how such a process is possible, provide a history of how the literature discovered such information, and give an interpretative perspective on how to judge what we now know. The story, I think, makes good reading.

Three principles

In 1950, Jacob Viner wrote *The Customs Union Issue*. The world had just witnessed the effects of the Great Depression and seen it cut short only by the intrusion of world war. But the war was over. It was not known whether its end might usher in a return of depression conditions. The United States set about establishing the International Monetary Fund to manage exchange rates and monetary matters, the International Bank for Reconstruction and Development (World Bank) to manage loans, and the International Trade Organization (ITO) to manage international trade. Through employment of the Marshal Plan and other initiatives, it was hoped that there would be no return to beggar-thy-neighbor policies and easy resort to politician-driven and selfish counterproductive national policies. The ITO never became reality because of concerns over how it would impact national sovereignty (there seems little reason to cede your sovereignty to nations that have demonstrated less ability to govern their affairs than your own), but the General Agreements on Tariffs and Trade, which was to be the treaty governing the free-trading club of signatory countries, *was* ratified and became the *de facto* controlling authority for international trade affairs until the World Trade Organization was established and began operation in 1995.

Viner began his investigation by doing what any pioneer would: he studied the simplest cases he could of the effects of forming a customs union on the welfare of member countries and the non-participant rest of the world. Unfortunately, he found troubling news. Forming a customs union was no guarantee that the members would be better off after formation. Expanding an existing union likewise gave no guarantee that the joining member would be better off.

A customs union is but one of a string of structural forms that imply greater economic integration. Its primary distinguishing feature is that countries inside the union freely trade goods and services with one another, but employ a common external tariff to apply to trade in goods with non-members. The following incomplete list displays some of the intermediate steps. The more integrated structures are at the top of the list. Because the European Union traversed through three steps in its history, changing names as it went, it forms a good example of the differences between a customs union, a common market and a regional union.

- **World Free Trade:** countries engage in unfettered commerce. Example, none.
- **One Country:** economic, political and military integration operating through a centralized authority. Free trade reigns internally. An example is the United States, formed from thirteen original colonies and the subsequent addition of other states.
- **Regional Union:** a common market that coordinates its currency, monetary and fiscal policies, often with centralized authorities established to do so. Example: the European Union.
- **Common Market:** a customs union that also freely trades in intermediates

and factors of production – for example, free flow of labor and capital is allowed. Example: the European Economic Community (EEC).

- **Customs Union:** a group of countries that frees trade with one another and applies a common external tariff to trade with non-members. Example: the European Economic Community.
- **Free Trade Area (FTA):** a group of countries that engage in free trade with one another, but apply tariffs and quotas (often different for different members) to the trade with non-members. Example: the North American Free Trade Area.
- **Trading Nations:** countries engage in trans-national trade with varying degrees of governmental interference. Example: most of the members of the World Trade Organization.
- **Autarky:** the state of no economic dealings with the outside. Example, an isolated tribal group (if any remain) in the forests of Papua New Guinea.

With no guarantee that doing the right thing will reward the doer, it is difficult to argue that moving up the list towards free trade makes economic sense. Consider the case of Britain as it joined the European Economic Community (EEC). Buying many of its imports, including foodstuffs and agricultural goods, from Commonwealth nations such as Australia, it enjoyed favorable prices for a range of commodities. As a member of the European Economic Community it would be expected to adopt the EEC common external tariff that would divert British trade to EEC suppliers who had higher prices, but were differentially advantaged because of the effect of the tariffs. *Trade diversion*, therefore, might overwhelm *trade creation* (the shift of trade to lower-cost suppliers made possible because of the removal of trade barriers between union members) leading to welfare losses. This may in fact have happened to Britain in the 1970s.[3]

In subsequent years, the problem found with Viner's terminology was that it was not always accurate. For example, trade diversion in the presence of either substitutability in production or substitutability in consumption was not always welfare-reducing. As late as the 1970s, research was being published making points of refinement to the applicability of the framework.[4]

The Treaty of Rome, signed in 1957, was the beginning of what would eventually become the European Union. Trade theorists therefore continued their efforts to better understand the effects of trade liberalization. A comment on the subsequent literature by Murray Kemp (1969) summarizes the state of affairs:

> In reviewing the professional and journalistic literature on preferential trading arrangements I have been struck by the fragmentary and partial equilibrium character of the formal models employed.… The poverty of the theory is more puzzling in that almost all of it has been developed since 1950, a period during which the rest of trade theory has fallen under the powerful unifying influence of the general-equilibrium approach developed by Hecksher, Ohlin, Lerner and Samuelson.… Most of the professional literature on preferential trading arrangements is exceedingly dull. The

> explanation lies in the multitude of "cases" which must be examined if the treatment is to be complete.

Even though, as a technical matter, the classification was flawed, it did remain a useful mnemonic that reminded the observer that competing effects were at work. As a precursor to the European Coal and Steel Community, European Economic Community and, eventually the European Union, it was good enough.

Isolation

In addition to the effect of FTA formation on member countries, there was concern over the impact on non-participant country welfare. Jaroslav Vanek (1962) devised the idea of using terms of trade changes to "compensate" the rest of the world for its troubles when countries A and B formed a customs union. From there, it was intellectually a small step to compensate the rest of the world fully to the point of unchanged welfare. Because the only avenue of welfare spillover to non-participants was through terms of trade, this realistically meant putting world terms of trade back to original levels, pre-formation levels. Vanek's work eventually resulted in his 1965 work, *General Equilibrium of International Discrimination: The Case of Customs Unions*. Murray Kemp visited Harvard at this period and interacted with Vanek. Similar ideas made their way into the edition of Kemp's 1964 text, *The Pure Theory of International Trade*.

Freezing world prices, and hence conditions, meant that world welfare would be unaffected by FTA formation and that participating countries could isolate efficiency-generating changes and accrue the benefits to themselves. Although technically known to practitioners, the isolation principle did not truly become common currency until Kemp and Wan (1976) published "An Elementary Proposition Concerning the Formation of Customs Unions". The authors modestly stated that "in the welter of inconclusive debate concerning the implications of customs unions, the following elementary yet basic proposition seems to have been almost lost to sight".

> Consider any competitive world trading equilibrium, with any number of countries and commodities, and with no restrictions whatever on the tariffs and other commodity taxes of individual countries, and with costs of transport fully recognized. Now let any subset of the countries form a customs union. Then there exists a common tariff vector and a system of lump-sum compensatory payments, involving only members of the union, such that there is an associated tariff-ridden competitive equilibrium in which each individual, whether a member of the union or not, is not worse off than before the formation of the union.

Kemp and Wan puzzled over their result's strong implications and weak application. Among the reasons they listed for impediments to the above theorem

leading nations to move stepwise to free trade in a series of ever larger customs unions was ignorance "concerning the long list of lump-sum compensatory payments required" and "the noneconomic objectives of nations".

Grinols (1981) subsequently resolved the former problem by showing that each country should be paid an amount equal to $p^1 \cdot z^0$, the value of its pre-union trade z^0 evaluated at post-union internal prices p^1. Such transfers satisfy a revealed preference property at the country level, and are necessary and sufficient in the sense that they always support the desired result and under certain circumstances are the only transfers feasible to achieve a Pareto Superior allocation in a Kemp–Wan customs union. Further, when the common external tariff is chosen to freeze world prices, as Kemp–Wan specified, the transfers are self-financing because their sum equals the tariff revenues of the union as a whole. It therefore becomes a tariff-sharing formula.[5]

After the lag of twenty-five years it was learned how to extend the theory of customs union formation to free trade areas, making use of rules of origin and a more restrictive isolation principle that froze members' individual country trades with the rest of the world. See Panagariya and Krishna (2002), Grinols and Silva (2005, 2007a, 2007b).

Intervention

At the time that progress was being made in customs union theory, a separate strand of research was underway relating to ranking of policy interventions, both to achieve non-economic objectives and to correct distortions (impediments to efficient market outcomes). Relevant contributions include the important work of Baldwin (1948), Corden (1957, 1971, 1986), Johnson (1965), Kemp and Negishi (1969), Bhagwati (1971), Dixit (1985) and Grinols (1987a), among others. A general modern statement of the intervention principle is contained in Grinols (2006). As time passed a better characterization emerged and the underlying principle could be stated, that the most efficient way to accomplish a desired objective is to identify the margin to be influenced and impose a tax or subsidy narrowly at that margin at the minimal level needed to accomplish the objective. The essence of the theorem can be seen by a modification of Theorem 1 of Grinols (2006):

> Allow every agent to face possibly unique prices due to possibly agent-specific taxes and subsidies. Let a list the production, consumption, and trade quantities that describe the economy's allocation. Then an initial allocation a^0 is optimal if and only if any movement from that position lowers welfare measured as
>
> $$\Delta W \equiv -S - \beta \cdot (a^0 - a^1) \leqslant 0$$
>
> for any feasible alternative a^1. S is a particular set of terms representing production and consumption flexibility in response to price changes and β is a

vector of tax wedges (possibly all zero) conformable to a describing the initial equilibrium. An example of the theorem's application is as follows. Assume that the noneconomic objective is to increase the supply of labor L_i of household *i*, $L_i \geqslant \phi$ for some choice of ϕ. The candidate efficient policy is a subsidy to labor supply that achieves the target at the least level. Assume that the objective has been achieved under this policy in the initial equilibrium:

$$\beta = (0, \ldots, s_i^L, \ldots, 0)$$

By the theorem this choice of tax intervention β is optimal if

$$-S - s_i^L \cdot (L_i' - L_i^0) \leqslant 0$$

Regularity conditions for $S \geqslant 0$ can be shown. Thus, because $L_i^0 = \overline{\phi}$ by assumption, any other policy that also achieves the objective satisfies $-s_i^L \cdot (L_i^1 - \phi) \leqslant 0$. Thus the described policy is, indeed, superior to any alternative.

The power of the result lies in the generality with which general interventions can be characterized and the degree to which non-economic objectives can be specifically identified and achieved. Applications in international trade theory and domestic public finance abound. Second-best interventions (ones that raise welfare from an initial position but do not necessarily move the economy to the best intervention position) can be described. Finally, conditions under which $S \geqslant 0$ can be catalogued. For example, there are still things that can be said about the non-negativity of S in the presence of increasing returns to scale in production.

Used with the isolation principle, the intervention principle allowed economists to address some of the impediments to trade reform such as non-economic objectives discussed by Kemp, Wan, and others. The final missing ingredient, however, was a good way to spread the gains to all agents so that no one loses.

Exchange rights

The simpler the principle, the broader its application. In consumer theory, for example, the consumer who is observed to select bundle A when bundle B is also feasible reveals that bundle A is preferred. If bundle B is the consumer's consumption in the initial situation, then we can infer that the change that led to the choice of A cannot have hurt the consumer. This principle underlies the necessary and sufficient cross-country compensation formulae described above.

An equally direct, but broadly applicable, principle leads us to a way to decentralize the implementation of the needed transfers through the incentives that agents have to protect their own interests. We start from the following fact: a selling agent "wins" when price rises, a buying agent "wins" when price falls. Moreover, each agent knows his or her own interest. The change in price times quantity transacted is a measure of the gain or loss to the agent. Consider then,

the impact of ascribing to each agent property rights in exchanges conducted in a reference equilibrium: whatever the direction of price changes, one side to the transaction has an incentive to enforce the original contract. The original contract can be enforced by physical production and/or exchange of goods, or by agents transferring the appropriate purchasing power. If you sell me a dozen eggs at $2 per dozen, for example and the price rises to $3 per dozen in the new regime, then I can require that you make good to me the change. You could either sell me a dozen eggs for $2, which you either produced yourself or acquired in the market, or you could transfer to me the $1 difference I need to buy them myself. Whether you produce the eggs yourself, acquire them in the market to sell to me or transfer the corresponding change in value is immaterial. As long as exchange rights are enforced, the new equilibrium must have the property that no agent is harmed by the change because the agents have the ability to enforce their original exchanges if they so choose.

The following describes the exchange rights procedure:[6]

1. The rights of agents to receive and deliver the original quantities at original prices are enforced by the state.
2. All markets in the new equilibrium are open in competitive fashion for exchanges.
3. Producers may meet their exchange rights obligations through their own physical production and delivery, through purchase for physical delivery, or by equivalent pecuniary exchanges. Once these obligations are met, profits from firm activities are retained by the firm.
4. Consumers likewise meet their exchange rights obligations, and maximize utility given their budgets, endowments and exchange rights commodities. Reselling of plan-enforced goods is permitted.

The essence of the exchange rights principle can be seen by the following calculation. Using standard terminology and notation, let x_i be the consumption vector of household *i*, let y_j be the production vector of firm *j*, and let ω_i be the endowment of household *i*, all K-dimensional to match the number of goods. Household *i* owns share $\theta_{ij}=0$ of firm *j* and prices are *p*.[7] Superscripts 0, 1 denote the pre- and post-reform situations, respectively. Then, with exchange rights enforced, the budget constraint of household *i* is:

$$p^1 \cdot x_i^1 \leqslant \sum_j \theta_{ij}^1 p^1 \cdot y_j^1 + p^1 \cdot \omega_i + \text{Exchange rights transfer}_i$$

where

$$\text{Exchange rights transfer}_i = \left(\sum_j \theta_{ij}^1 p^0 \cdot y_j^0 - \theta_{ij}^1 p^1 \cdot y_j^0 \right) + (p^0 - p^1) \cdot \omega_i + (p^1 - p^0) \cdot x_i^0$$

Notice that we do not enforce the requirement that $\theta_{ij}^1 = \theta_{ij}^0$, even though this may be the most common circumstance. Rewriting the right-hand side of the consumer's budget constraint shows that it equals

$$p^1 \cdot x_i^0 + \sum_j \theta_{ij}^1 p^1 \cdot (y_j^1 - y_j^0) + \left(p^0 \cdot \omega_i + \sum_j \theta_{ij}^0 p^0 \cdot y_j^0 - p^0 \cdot x_i^0 \right) \geqslant p^1 \cdot x_i^0$$

where we have used the fact that

$$\sum_j \theta_{ij}^0 p^0 \cdot y_j^0 + p^0 \cdot \omega_i - p^0 \cdot x_i^0 \geqslant 0$$

because the consumer's budget constraint is satisfied in the pre-reform situation, and $p^1 \cdot (y_j^1 - y_j^0) \geqslant 0$ because firms maximize profits in the post-reform regime. The consumer therefore has enough income to purchase the original consumption bundle x_i^0 and by revealed preference cannot be worse off.

The significant result in this setting is that the required Pareto-improving equilibrium exists and that it is equivalent to a standard competitive equilibrium with modified endowments: "Under standard assumptions on consumption and production, there exists an efficient Pareto-improving competitive equilibrium in which exchange rights are enforced."[8]

Conclusion

The isolation, intervention and exchange rights principles are significant advances in our understanding of markets, of commercial interactions and of our ability to use them to improve agent welfare. The First and Second Fundamental Theorems of welfare economics indicate that prices and competitive equilibria are intimately connected, indeed essentially equivalent, to the notion of Pareto efficiency. The three principles remind us that market outcomes are built up as the sum of individual, firm, and household decisions to maximize profits and utility. The achievement of Pareto optimality is, therefore, a decentralized phenomenon and, likewise, its failure to be achieved can be understood on the same terms. We now know that the inefficient sector – a list of firms, households and endowments – can be isolated according to the isolation principle, moved to within-sector efficiency, and the gains from the adjustment collected for the benefit of the within-sector households whose actions led to the gains. We also know, through application of the exchange rights mechanism, that individuals will have the incentive to pursue their own utility-protecting transfers in a decentralized manner. If within-sector non-economic objectives are imposed, the intervention principle says that they can be pursued in an efficient way and that while their imposition on the system will lower the potential for gains, conservative non-economic objectives will not destroy the Pareto improvement altogether. The "sector" is a general enough concept that it can be applied in a myriad of useful ways, ranging from between-country initiatives like free trade areas and customs unions, to intra-country regional development projects.

Notes

1 See Grinols and Perelli (2004, 2006).
2 Grinols and Silva (2007a) report on this.
3 See Grinols (1984).
4 See for example Krauss (1972), Collier (1979) and the earlier survey Lipsey (1960).
5 A country could receive a negative share of revenues.
6 See Lau *et al.* (1997).
7 Negative shares can be accommodated, but to keep the discussion simple we assume non-negative shares.
8 Lau *et al.* (1997).

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Part VI

Afterword

Afterword

Joseph A. McKinney and H. Stephen Gardner

The trade policy community is quite disappointed with the progress made during recent years toward trade liberalization at the multilateral and regional levels. The contributors to this volume have reflected that disappointment, and have reviewed many of the problems that stand in the way of progress. Mario Marconini found that the overall trading system "seems to be wandering aimlessly, in search of an agenda or a reason to hold itself together". Supachai Panitchpakdi fears that our continuing difficulties will endanger nothing less than the "future of multilateralism and ... efforts to make trade an engine of growth".

While it has become apparent that the Free Trade Area of the Americas is not developing as intended, economic integration in the Western Hemisphere nevertheless continues to widen and deepen. To a large extent it is the silent integration of market forces deepening economic interconnections among countries as transactions costs are reduced by technological developments and as former restraints on market activities are removed by economic reforms. In addition, a large number of regional and subregional trading arrangements have been put into place in recent years in the Western Hemisphere. Sometimes these have involved several countries in formal integration arrangements, but often they have consisted of bilateral free trade agreements.

Given these developments, what are the prospects for regional economic integration in the Americas? The bilateral and subregional agreements that have been signed have both disadvantages and advantages. Certainly the differing provisions of the various agreements, particularly with regard to rules of origin, add complexity to regional trading environment. At the same time, trade liberalization and economic reforms brought about by the agreements should make eventually blending the agreements into a common agreement for the hemisphere more feasible.

Also, the negotiations for a Free Trade Area for the Americas have in themselves had positive effects. They have been an important learning laboratory for many of the Latin American countries that were inexperienced in the negotiating process. The three major organizations focused on Latin America, the Inter-American Development Bank (IDB), the Organization of American States (OAS), and the United Nations Economic Commission for Latin America and the Caribbean (ECLAC), have worked hard to assist countries in Latin America

to develop their trade-negotiating capacity. Personnel from the IDB, the OAS, and ECLAC have attained a new level of cooperation and information-sharing as a result of working jointly on the FTAA negotiations. Transparency with regard to trade flows and trade practices in Latin America has been greatly enhanced by the information that has been systematically collected and organized. Linkages have been established between trade officials and civil society groups that would not have occurred otherwise. The attempt to negotiate an agreement that was WTO-consistent heightened awareness of the nature of the multilateral system and strengthened linkages to it. Subregional cooperation was enhanced as the members of subregional groups worked to attain a common position for the negotiations.[1]

That there is significant interest in a hemispheric agreement is indicated by the fact that in the Declaration of Mar del Plata signed at the Fourth Summit of the Americas in November 2005, twenty-nine of the thirty-four countries indicated a desire to go ahead with the Free Trade Area for the Americas. No real progress toward a hemispheric agreement is likely until the matter of agricultural subsidies is settled at the multilateral level in the Doha Development Round. After that is settled and energies can be directed toward hemispheric trade issues, it is possible that the various bilateral and subregional agreements that have been put into place could be blended and subsumed into a hemispheric trade agreement. Much will depend on political developments in Latin America in the years ahead, and also on how the United States Congress deals with the political pressures arising from the rapid economic change brought about by globalization.

Levels of intra-regional trade within Latin America (particularly in South America) are very low compared to other regions. Latin America's share (excluding Mexico) of United States trade is low and has been declining for several decades. Considerable potential exists for trade and investment expansion in the Americas, but this will require improvements in transportation and communications infrastructure and a strengthening of institutions for its full realization. Much of the hard work for a hemispheric free trade agreement has been done over the past several years by working groups established to address particular issues. Eventual success or failure of the initiative will depend on the ability of governments to recognize the benefits, both economic and non-economic, of hemispheric economic integration, and their willingness to expend political capital to bring these benefits within reach.

Note

1 Points in this paragraph were made by Robert Devlin in his conference presentation.

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