ANNUAL WORLD BANK CONFERENCE ON

TRADE: TOWARDS OPEN REGIONALISM

1997

Edited by
Shahid Raza and Guillermo F. Perry
Sara Cahan

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1997

TRADE: TOWARDS OPEN REGIONALISM

Proceedings of a Conference held in
Montevideo, Uruguay

Edited by
Shahid Javed Burki
Guillermo E. Perry
Sara Calvo

The World Bank
Washington, D.C.
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Introduction
Towards Open Regionalism

Shahid Javed Burki
Guillermo E. Perry

It is a great pleasure to welcome everyone to the Third Annual Bank Conference on Development in Latin America and the Caribbean (ABCD-LAC). Our first conference, held in Rio de Janeiro, focused on the challenges of reform. Our second conference, held in Bogotá, focused on poverty and inequality. And this, our third conference, here in Montevideo, will focus on trade. Thus, aptly, the title of this conference is “Trade: Towards Open Regionalism.”

Each subject these ABCD-LAC conferences has covered has been of vital importance to the future stability and success of Latin America and the Caribbean. This year’s subject, trade, is of equal importance, and why that is so will become explicitly clear as we hear from our various speakers, discussants and other participants during the next two days.

Trade policy can have a significant impact on the health or sickness of our economies and, thus, on our future well-being. Trade policy can make all the difference between stumbling and struggling to achieve gains for our countries, and having a truly vibrant economy that can lead to vibrant, fulfilled lives for our citizens. So let us understand just how important trade policy is. It is not summarized simply by some mathematical equation put forth by our gifted economists. At the end of the day, trade policy affects the lives of our peoples, and that is something we must always keep in mind.

The World Bank and Trade Policies in LAC

The World Bank has supported liberal trade policies for a long time. In addition to strong theoretical arguments in favor of open trading regimes, there is overwhelming empirical evidence, both in LAC and worldwide, that such policies promote economic development. In turn, economic growth is a necessary condition for reducing poverty, and therefore greater openness will help reduce poverty. Furthermore, trade liberalization ensures that long-term economic growth in LAC will be more labor intensive, which helps poverty reduction as greater shares of national incomes are received by workers. Consequently, when most of the region was practicing protectionist, inward-looking trade policies, the World Bank was promoting a change in outlook. When most of the region dismantled its protectionist regimes in the late 1980s and early 1990s, the World Bank was there to help with technical assistance and with structural adjustment and trade-reform loans. We also supported the establishment or strengthening of safety nets to protect the poor from any potential short-term consequences of the rapid pace of reform. And now we support a policy of “open regionalism” for Latin America and the Caribbean.

Why Do We Use the Term “Open Regionalism”? Regional integration in LAC, or regionalism, needs to be assessed from a historical perspective. LAC regional inte-
TRADE TOWARDS OPEN REGIONALISM

In the 1960s and 1970s had both a positive and a negative aspect. On the positive side, the regional liberalization of trade flows provided at least a limited space for greater competition, thus promoting efficiency and export development in an otherwise closed environment. On the negative side, because regionalism was designed to extend the rapidly declining scope for import substitution, by providing an enlarged space for a second phase of the protectionist model it may have retarded the process of trade and investment liberalization.

The revival of regional integration in the early 1990s is clearly a different process. The new regionalism has emerged as a by-product of the decisions made by most governments to liberalize their economies. In general, it has proceeded hand in hand with unilateral trade liberalization and the opening to foreign investment.

The evolution of tariff and non-tariff measures affecting imports from the rest of the world. Figures 1 and 2 show that protectionist policies have been dismantled in the major LAC countries during the last decade, and especially since 1991. Furthermore, Table 1 shows the same pattern for Mercosur countries when comparing the average tariffs imposed by its member countries in 1986 with those included in the Ouro Preto Treaty objectives. These facts leave no doubt that regionalism has gone hand in hand with unilateral trade opening in the last decade, in sharp contrast with what happened in the 1960s and 1970s. That is one reason why we talk of “open” regionalism in LAC today.

The same is true with respect to investment flows. Regionalism in the 1990s has gone hand in hand with a substantial liberalization of investment regimes. Nowadays, several countries in LAC treat foreign direct investment (FDI) on exactly the same footing as domestic investment. New regional trading arrangements (RTAs) have explicit provisions to facilitate investment flows, including national treatment provisions. This is in sharp contrast to the restrictive regimes of the 1960s and the 1970s in most LAC countries. Table 2 shows that in fact FDI has become an important and increasing contributor to domestic investment. This is a second reason why we talk of open regionalism in LAC today.

Also, the recent surge of regionalism has not promoted “closed clubs” as some observers feared. On the contrary, what we have seen is a trend to enlarge memberships and to

FIGURE 1
Weighted Average Import Charges in LAC, 1984–93
(weighted by a product’s share of world trade flows)

superimpose a host of free-trade arrangements. Mercosur has signed trade agreements with Chile and Bolivia, and is busily negotiating new ones with the Andean Community and with the European Union. Colombia and Venezuela signed a joint free-trade agreement with Mexico (the so-called Group of Three); the fact that Mexico was a member of the North American Free Trade Agreement (NAFTA) and that Colombia and Venezuela were members of the Andean Pact in 1994 did not deter this development.\footnote{Tables 1 and 2}

These three countries have signed bilateral free-trade agreements with Chile, irrespective of their other memberships. Finally, most LAC countries have expressed their willingness to participate in the construction of a hemispheric free-trade zone and have been active, pro-liberalization members of the World Trade Organization (WTO). This is a third reason why we talk of open regionalism in LAC today. Yet a legitimate question to ask is, Why has regionalism accompanied unilateral trade liberalization?

### TABLE 1
**Unilateral and Regional Trade Liberalization in Mercosur: Average Tariffs by Country**

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>1986</th>
<th>OURO PRETO OBJECTIVES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>41</td>
<td>12</td>
</tr>
<tr>
<td>Brazil</td>
<td>80</td>
<td>13</td>
</tr>
<tr>
<td>Paraguay</td>
<td>20</td>
<td>9</td>
</tr>
<tr>
<td>Uruguay</td>
<td>36</td>
<td>11</td>
</tr>
<tr>
<td>Mercosur</td>
<td>44</td>
<td>11</td>
</tr>
</tbody>
</table>


### TABLE 2
**Net Foreign Direct Investment as a Share of Gross Domestic Investment, 1980–95**

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>1980–84</th>
<th>1985–89</th>
<th>1990–95</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>2.4</td>
<td>4.5</td>
<td>6.7</td>
</tr>
<tr>
<td>Brazil</td>
<td>4.4</td>
<td>2.1</td>
<td>2.1</td>
</tr>
<tr>
<td>Chile</td>
<td>6.4</td>
<td>6.6</td>
<td>8.2</td>
</tr>
<tr>
<td>Colombia</td>
<td>5.3</td>
<td>8.0</td>
<td>9.9</td>
</tr>
<tr>
<td>Mexico</td>
<td>3.0</td>
<td>6.7</td>
<td>8.8</td>
</tr>
<tr>
<td>Peru</td>
<td>0.2</td>
<td>0.6</td>
<td>9.6</td>
</tr>
<tr>
<td>Venezuela</td>
<td>0.7</td>
<td>1.0</td>
<td>9.0</td>
</tr>
</tbody>
</table>

Source: World Bank World Development Indicators Database.
Why Has Regionalism Accompanied Unilateral Trade Liberalization?

Although it is a legitimate intellectual exercise to ask whether it would not have been more convenient to have had only unilateral liberalization without the new RTAs, we think it is more interesting to ask why unilateral opening was accompanied by the revival of regionalism. Let me refer to a similar question posed by Professor Paul Krugman to free-trade advocates. He asks, Why is it that free-traders support WTO and GATT negotiations when, on purely theoretical grounds, they should oppose them? In fact, trade theory suggests that countries should unilaterally liberalize to reap the benefits of freer trade, even if others do not do so. Then why doesn’t it happen? Why don’t we see unilateral trade liberalization taking place throughout the world? Why do we need an international organization like the WTO?

Of course, political economy considerations come into play. There are interests that oppose unilateral trade liberalization; there are those who think in mercantilistic terms (“exports are good, imports are bad”) even if economic theory would prove them wrong. When free-traders support WTO negotiations, they are implicitly accepting these constraints.

Let me suggest that there may be similar motives driving the process of unilateral liberalization accompanied by RTAs. It is easier to have public opinion on your side, and to counteract opposing interests, in favor of “integration” with your neighbors and/or for securing access to foreign markets for exporters through reciprocity, than it is for unilateral liberalization. A policy “package” that contains both unilateral liberalization and RTAs with your trading partners is likely to receive greater political support than one that is limited to unilateral liberalization.

But this is only one reason why policymakers may have chosen to engage in both processes simultaneously. Let me also suggest that securing access to crucial markets may indeed be worth some costs. Even if your trading partners liberalize today, they may change their minds in the future. To “lock-in” access to export markets by imposing costs to “exit” RTAs makes some sense. For example, investors in Mexico appreciate the more secure access that NAFTA provides to the U.S. market. Investors in Argentina, Uruguay or Paraguay similarly appreciate the insurance that the Mercosur treaty provides regarding their gained access to the Brazilian and each other’s markets. The same goes for investors in Colombia and Venezuela, who benefit from greater certainty about the future access to their respective markets that is preserved by the Andean Community agreements. This consideration may provide an important motivation for many LAC countries to sign freetrade treaties with the United States. Even if the United States is generally open, once in a while there are protectionist impulses affecting imports of particular products, some of which are precisely those in which LAC countries are more competitive. This reciprocal “lock-in” effect reduces uncertainty and risks, and may thus increase investment levels.

It also makes sense to “lock yourself in.” Making liberalization credible is often a necessary condition to ensure that sound economic policies will yield their benefits. If investors fear that liberal policies may be reversed, they may invest less or nothing at all. “Locking in” through RTAs increases the credibility of trade and investment opening, because RTAs raise the “costs” of policy reversals. “Entry costs” also enhance credibility, because the negotiations leading to RTAs and their implementation require the use of public resources and political capital, which signal a government’s commitment to trade and investment liberalization. Why would a government go through all these lengthy negotiations if it is not really committed to keeping the economy open? Notice that these arguments that emphasize “locking-in” effects imply that the economic motivation behind RTAs is more related to their effects on investment than on trade itself.

It should not come as a surprise to anybody that the new RTAs have come at the same time as the new surge in FDI and other capital flows in a world of higher financial integration. Countries want to share the bonanza by giving more credibility to their policies and more certainty to their access to foreign markets. Of course, the credibility of macroeconomic policies may rank higher in investor concerns than credibility of trade policies, but the latter may be a useful complement to credible stabilization and structural reforms.

In sum, there are both political economy and purely economic arguments that support the political decision to move forward with unilateral trade liberalization and regionalism. In any event, there is little doubt that they were part and parcel of the same political decision to integrate LAC economies into the global economy, and we could even argue that one process would not have hap-
pened without the other in many LAC countries. There is, thus, a case to judge jointly the outcome of both processes and not to attempt an artificial separation in the analysis.

There are other non-economic reasons for joining RTAs. A well-known argument is that integration enhances the capacity to influence worldwide outcomes. Although it is doubtful that RTAs significantly enhance the voice of developing countries in the WTO, it is a fact that a strong Mercosur has changed the landscape for future negotiations of a free-trade zone in the Western Hemisphere.

A new argument is that RTAs may contribute to democratic consolidation if maintaining a democratic regime is a prerequisite for continued membership. This type of “political lock-in” consideration weighs heavily in today’s efforts of Central European countries to join the European Union. While it may be less important in LAC, last year’s events in Paraguay suggest that this may indeed be an important consideration for LAC countries. A less-publicized political consideration is that RTAs, by strengthening business links across countries, reduce the likelihood of conflicts between countries that have border disputes. A similar “peace lock-in” effect has been a prime mover behind the EEC initiative since the 1950s.

**What about the Results?**

Coming back to hard economic facts, overall trade trends in the 1990s provide justifications for optimism. It is true that LAC intra-regional imports and exports grew rapidly in the first half of the 1990s, but imports from the rest of the world grew even faster than intra-regional imports. Moreover, exports to the rest of the world have grown somewhat less rapidly than intra-regional trade, but still at faster rates than during the late 1980s (see Table 3). When one looks at the data for each subregional grouping, it becomes evident that intra-regional imports have grown more rapidly than imports from the world in all cases except CARICOM. However, trade with the rest of the world has in all cases grown at very high rates, certainly higher than in the late 1980s (see Table 4).

These aggregate figures cannot be taken as definite proof that healthy trade creation has outweighed any inefficient trade diversion, but they certainly do not give much support to the opposing argument.

It is true, however, that we are concerned about inefficient trade diversion in some instances. Several studies, conducted at the World Bank and elsewhere, have produced evidence of this sort of effect for specific sectors in some regional groupings. Such cases are usually the outcome of exceptions to the general policy: They are remnants of trade distortions of the past that were designed to protect specific sectors. Such distortions do not promote economic efficiency, nor do they help the poor, and thus, as I have said before, we are all obliged to point them out, hoping that they will be corrected as soon as possible. Such may be the case with those sectors under special regimes or higher common external tariffs in Mercosur. We are well aware, of course, that in some instances there may be some room for gaining economies of scale and dynamic benefits that partly compensate for some of those hopefully short-term inefficiencies. In general, though, we would urge the countries to accelerate convergence toward lower and more uniform tariff levels.

There are also other problems created by recent developments. The array of overlapping trading arrangements is creating distortions and difficulties, especially in the enforcement of rules of origin and other complex technicalities. As Enrique Iglesias, one of the champions of

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**TABLE 3**

<table>
<thead>
<tr>
<th>A. EXPORTS FROM LAC</th>
<th>1986–90</th>
<th>1991–95</th>
</tr>
</thead>
<tbody>
<tr>
<td>WORLD</td>
<td>6.4</td>
<td>11.8</td>
</tr>
<tr>
<td>1. LAC</td>
<td>11.3</td>
<td>16.0</td>
</tr>
<tr>
<td>2. ROW</td>
<td>5.7</td>
<td>11.0</td>
</tr>
<tr>
<td>INDEX</td>
<td>5.0</td>
<td>4.0</td>
</tr>
</tbody>
</table>

**B. IMPORTS TO LAC**

<table>
<thead>
<tr>
<th>FROM</th>
<th>1986–90</th>
<th>1991–95</th>
</tr>
</thead>
<tbody>
<tr>
<td>WORLD</td>
<td>9.3</td>
<td>17.7</td>
</tr>
<tr>
<td>1. LAC</td>
<td>8.6</td>
<td>16.8</td>
</tr>
<tr>
<td>2. ROW</td>
<td>9.5</td>
<td>18.0</td>
</tr>
<tr>
<td>INDEX</td>
<td>-1.0</td>
<td>-1.0</td>
</tr>
</tbody>
</table>

ROW = Rest of World
INDEX = [(1+LAC)/(1+ROW)]−1+100; if INDEX > 0, intra-LAC trade growth was faster than trade with ROW.

Note: LAC includes the developing countries of the Western Hemisphere (i.e., intra-LAC trade does not include trade between LAC countries and Canada and the United States).

In principle, intra-LAC exports and imports should be equivalent, but the differences in this data reflect the incidence of transportation costs; hence the difference between the rate of growth of exports from LAC to LAC and the growth rate of imports from LAC to LAC.

Source: International Monetary Fund, Direction of Trade Statistics.
TABLE 4
Intra-Regional Import Growth in LAC, 1986–90 and 1991–95
(growth rates of imports value in US$, CIF)

<table>
<thead>
<tr>
<th>Region</th>
<th>1986–90</th>
<th>1991–95</th>
</tr>
</thead>
<tbody>
<tr>
<td>intra-MERCOSUR</td>
<td>18.3</td>
<td>24.6</td>
</tr>
<tr>
<td>from ROW</td>
<td>7.9</td>
<td>19.7</td>
</tr>
<tr>
<td>INDEX</td>
<td>9.9</td>
<td>4.0</td>
</tr>
<tr>
<td>1986–90</td>
<td>1991–95</td>
<td></td>
</tr>
<tr>
<td>intra-ANDEAN</td>
<td>9.8</td>
<td>34.6</td>
</tr>
<tr>
<td>from ROW</td>
<td>2.7</td>
<td>16.0</td>
</tr>
<tr>
<td>INDEX</td>
<td>6.9</td>
<td>16.0</td>
</tr>
<tr>
<td>1986–90</td>
<td>1991–95</td>
<td></td>
</tr>
<tr>
<td>intra-CACM</td>
<td>3.0</td>
<td>20.8</td>
</tr>
<tr>
<td>from ROW</td>
<td>3.7</td>
<td>15.6</td>
</tr>
<tr>
<td>INDEX</td>
<td>-2.5</td>
<td>4.5</td>
</tr>
<tr>
<td>1986–90</td>
<td>1991–95</td>
<td></td>
</tr>
<tr>
<td>intra-CARICOM</td>
<td>6.7</td>
<td>-8.0</td>
</tr>
<tr>
<td>from ROW</td>
<td>0.4</td>
<td>5.3</td>
</tr>
<tr>
<td>INDEX</td>
<td>6.2</td>
<td>-12.6</td>
</tr>
</tbody>
</table>

ROW = Rest of World
INDEX = [(1 + LAC)/(1 + ROW)] - 1. When INDEX > 0, intra-LAC imports growing faster than imports from ROW.

MERCOSUR = Argentina, Brazil, Paraguay and Uruguay
ANDEAN = Bolivia, Colombia, Ecuador, Peru and Venezuela
CACM = Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua
CARICOM = Bahamas, Barbados, Belize, Guyana, Jamaica, St. Kitts and St. Lucia

Source: International Monetary Fund, Direction of Trade Statistics.

regional integration in LAC, stated in his speech at the recent Inter-American Development Bank annual meeting, it is time to begin to tackle some of these problems in a systematic way. Also, it is particularly worrisome that some of the small economies, particularly in Central America and the Caribbean, have been left out, temporarily, of some of the action and have consequently suffered some erosion of their previous preferential access to some markets without gaining new terrain.

What is the evidence on FDI flows? In the case of Mexico, there appears to have been a strong response to NAFTA from non-NAFTA countries, but not from U.S. firms. The combination of locational advantage and secure and preferential access to the U.S. market was a powerful incentive for non-U.S. firms to establish themselves in Mexico. Such access was, of course, less important for U.S.-based FDI. Some U.S.-based firms now have fewer incentives to invest in Mexico to have access to its market. In other words, “tariff-jumping” incentives to invest in Mexico disappeared for U.S.-based firms. As a matter of fact, U.S.-based FDI reacted more vigorously to the deregulation of FDI in Mexico in the second half of the 1980s than to NAFTA.\(^6\) In fact, data published by the U.S. government shows that U.S. direct investment in Mexico grew at a much slower pace than that in other LAC countries during the early 1990s (see Table 5).

There has been a distinctive jump of total FDI flows to the Andean Community. Their share of FDI flows to the LAC Region increased substantially in the 1990s, which may be related to the vigorous market integration between Colombia and Venezuela. In contrast, there is no such evidence in the case of Mercosur (see Table 6), though last year’s figures looked promising. Changes in the composition of FDI in Mercosur countries seem more related to privatization efforts than to Mercosur itself. However, highly protected sectors in Mercosur countries have been attracting a higher proportion of that investment, a development that may prove to be not so desirable in the long run. In other words, FDI flows motivated by the market expansion effects of RTAs tend to be more welfare enhancing than FDI flows driven by “tariff-jumping” motivations.

That said, we must acknowledge that the jury is still out evaluating the outcomes of the recent revitalization of regionalism in LAC. Progress has been uneven across

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TABLE 5
United States: Average Annual Growth Rate of Direct Investment in LAC, 1991–95
(rate of change of dollar value of direct investment, measured at cost value)

<table>
<thead>
<tr>
<th>Region</th>
<th>GROWTH RATE</th>
<th>1995 SHARES</th>
</tr>
</thead>
<tbody>
<tr>
<td>To the World</td>
<td>11.3</td>
<td></td>
</tr>
<tr>
<td>Latin America &amp; the Caribbean</td>
<td>12.2</td>
<td>17.5</td>
</tr>
<tr>
<td>South America</td>
<td>17.6</td>
<td>38.3</td>
</tr>
<tr>
<td>Argentina &amp; Brazil</td>
<td>12.3</td>
<td>25.7</td>
</tr>
<tr>
<td>Chile</td>
<td>28.8</td>
<td>4.5</td>
</tr>
<tr>
<td>Andean Group (Col, Ecu, Per, Ven)</td>
<td>24.3</td>
<td>7.2</td>
</tr>
<tr>
<td>Mexico and Central America</td>
<td>7.0</td>
<td>25.6</td>
</tr>
<tr>
<td>Mexico</td>
<td>3.3</td>
<td>11.4</td>
</tr>
<tr>
<td>Caribbean</td>
<td>11.5</td>
<td>36.2</td>
</tr>
</tbody>
</table>


Note: Based on data on the direct investment position of the United States in LAC, which measures the value of the net accumulated stock of capital that U.S. parent companies provide to their foreign affiliates.
groups of countries and sectors. Action in trade in services and agricultural products has lagged behind other latitudes globally. Improving the infrastructure for integration remains a challenge. The case for harmonizing some trade-related policies, such as subsidies, indirect taxation, and competition policies is becoming more compelling. There is also the difficult question of how much macroeconomic policy coordination will be needed as integration deepens. Finally, at some point a dilemma may arise between “deepening” integration under current schemes, expanding memberships, and building a new free-trade area in the Americas.

We expect to cover all these rich topics in this conference. The purpose of the World Bank in choosing this subject matter for its Third Annual Bank Conference on Development in LAC is to promote a wide discussion of all issues that will be crucial for the success of both regionalism and development in the region. This choice underscores the importance the World Bank attaches to the process of building an open regionalism in the Western Hemisphere. We want to help promote a healthy, open regionalism and freer trade for the well-being of all LAC populations.

We have invited a very distinguished group of policymakers, academics and members of the private sector and multilateral institutions. Keynote speakers include President Enrique Iglesias of the IDB, Professor Jagdish Bhagwati of Columbia University and Mr. Joseph Stiglitz—until recently Chairman of the Council of Economic Advisors for the U.S. government, and currently Chief Economist of the World Bank. We thank them all for their cooperation and participation. And we are especially grateful to our host, Minister of Finance Luis Mosca, for the efficient organization of the conference and the warm welcome we have received.

We look forward to a productive and enjoyable meeting!

Notes
1. The presidents of Mercosur countries met in Ouro Preto, Brazil, on December 17, 1994. The “objectives” were the tariff levels that will be in place by 2006.
2. Such provisions are included in the agreements or treaties of the following LAC trading arrangements: Mercosur, Andean Community, Central American Common Market (CACM), Caribbean Community (CARICOM), NAFTA, Group of Three (Colombia, Mexico, Venezuela) and several bilateral agreements.
5. These arguments are further elaborated in Raquel Fernández (1997). “Returns to Regionalism: An Evaluation of Non-Traditional Gains from RTAs,” mimeo, International Trade Division, Development Economics Department, World Bank, Washington, D.C.

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TABLE 6
Growth of Net FDI to LAC Groups
(average annual growth rates of US$ values)

<table>
<thead>
<tr>
<th>REGION OR COUNTRY</th>
<th>SHARE OF TOTAL</th>
<th>1986–90</th>
<th>1991–95</th>
<th>1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>MERCOSUR</td>
<td>25</td>
<td>37</td>
<td>21</td>
<td>12</td>
</tr>
<tr>
<td>ANDEAN</td>
<td>22</td>
<td>10</td>
<td>35</td>
<td>57</td>
</tr>
<tr>
<td>CACM</td>
<td>2</td>
<td>19</td>
<td>21</td>
<td>56</td>
</tr>
<tr>
<td>CARICOM</td>
<td>3</td>
<td>122</td>
<td>21</td>
<td>22</td>
</tr>
<tr>
<td>MEXICO</td>
<td>27</td>
<td>12</td>
<td>38</td>
<td>56</td>
</tr>
<tr>
<td>CHILE</td>
<td>7</td>
<td>58</td>
<td>31</td>
<td>56</td>
</tr>
<tr>
<td>To all LDCs</td>
<td>52</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

MERCOSUR = Argentina, Brazil, Paraguay and Uruguay
ANDEAN = Bolivia, Colombia, Ecuador, Peru and Venezuela
CACM = Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua
CARICOM = Antigua & Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Jamaica, St. Kitts, St. Lucia, St. Vincent and Trinidad & Tobago

I. The Challenges of Regional Integration
The FTAA is *Not* Free Trade

**JAGDISH BHAGWATI**

When the Clinton Administration's spokespersons, or perhaps we should call them spin-masters, recently released the results of the commissioned study by the consulting firm DRI of NAFTA's economic effects, the public debate was so flawed analytically that it might as well have been taking place in a country populated by illiterates. Even the Lehrer News Hour, our justly celebrated intellectual news show, had Ambassador Mickey Kantor and Ms. Thea Lee debating the employment effect of NAFTA, when trade policy can generally affect employment only in specific sectors, not economy-wide.

The public debate over NAFTA, then and now, has suffered from a worse, even crippling confusion. Few in the media, and fewer still in the administration and Congress, understand that there is a world of difference between a free-trade area (FTA), which moves to free trade only among its members, and free trade (FT), which lowers trade barriers for all. Indeed, there are now many well-known free traders among economists who oppose FTAs and consider them a pox on the world trading system, so that the widespread assumption in the policy debate over NAFTA and Free-Trade Area of the Americas (FTAA)—that free traders support them and protectionists oppose them—is rank nonsense.

As it happens, the idea of the expansion of NAFTA to Chile, and eventually of an FTAA, which the Clinton administration is wedded to, is a mistake. There is an alternative trade policy that would better fit free trade as well as our regional objectives. But it has failed to be debated because the administration has consistently fudged the distinction between FTAs and FT, and because of the legacy of Ross Perot during the NAFTA debate, when to be anti-NAFTA came to be popularly regarded as being protectionist.

This fall, as we move in the direction of the FTAA under the false banner of free trade, there is still a window of opportunity to introduce Washington to the real issues about FTAs and even to stop the train in its tracks: Ideas can be potent. I intend, therefore, to argue here why FTAs, including the FTAA, are a bad idea, and to outline the alternative trade policy that we should embrace.

**Why Are FTAs Bad News?**

An FTA, because of the *inherent* discrimination that it implies in freeing trade, is different from free trade. Indeed, its flip side is protectionist—protectionist against non-members, against whom the *relative* protection is increased because barriers fall in favor of members, while the ones against non-members remain in place. Recalling Orwell, therefore, serious economists have now abandoned...
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the phrase Free-Trade Agreements for one that reminds us of what they truly are: Preferential-Trade Agreements (PTAs). Their preferential nature, and the huge growth in their number in the last decade, has raised alarms.

Trade Diversion: An important reason, first noted by Jacob Viner in 1950 in a pathbreaking study for the Carnegie Commission, is that the preferences create incentives to divert, not just create, trade. Thus, member countries, enjoying the enhanced protection vis-à-vis more efficient non-members, may replace them as producers and exporters within the PTA, distorting world trade and likely hurting themselves, since they buy imports more expensively from within the PTA.

The analytically informed proponents of PTAs have claimed that trade diversion is negligible in practice; Lawrence Summers, U.S. Deputy Secretary of the Treasury, has even remarked with characteristic forthrightness that he finds it "surprising that this issue is taken so seriously" and that it is a matter to "laugh off." But increasing numbers of empirical studies are now beginning to show that trade diversion is not a negligible phenomenon. Thus, World Bank economist Alexander Yeats's 1996 study of Mercosur (including Uruguay, Argentina, Paraguay and Brazil) turned up significant evidence of trade diversion.

The economists Jeffrey Frenkel and Sheng-Jin Wei have also concluded recently that the EU also has been characterized by more trade diversion than hitherto believed. The diversion of textile trade to Mexico from the Caribbean thanks to NAFTA, which excludes the latter and includes the former, has also been a source of discord.

Indeed, if one examines the administration-released DRI study of NAFTA's effects, one immediately finds prima facie evidence of trade diversion plaguing Mexico as well. Thus, according to the DRI study, while the peso crisis generally contracted Mexican domestic demand by 3.3 percent over the period, U.S. exports to Mexico increased by 36.5 percent (or $15.2 billion) from 1993 to 1996. U.S. share in Mexican imports thus went up from 69.3 percent to 75.5 percent. Equally, since NAFTA was signed, the Mexican tariffs on U.S. goods were reduced by an average of 7.1 percentage points, resulting in "a 10 percentage point average tariff advantage over foreign suppliers." The Mexican government should itself worry about this strong evidence of trade diversion toward the United States, which is celebrated in the DRI Report as if it were evidence of NAFTA's success! In fact, a quick back-of-the-envelope estimate by University of Maryland economist Arvind Panagariya suggests that Mexico's annual loss from this trade diversion could be as high as $3 billion.

The growing empirical evidence of trade diversion in these preferential-trade agreements is, in fact, not surprising because there has been abundant evidence that many business lobbies prefer them to genuine, multilateral free trade because they give them preferred access to foreign markets at others' expense. Just recall President Clinton's resort to Japan-bashing during the NAFTA debate: that it would give our firms a better access to Mexico over the Japanese. Economic theory, which often lags behind economic phenomena, has now demonstrated (in the work of Gene Grossman and Elhanan Helpman and Pravin Krishna) that, under plausible assumptions, trade diversion provides the key motivation for opting for preferential-trade agreements. It is not remarkable, therefore, that those who indulge their preference for preferential-trade arrangements are seen also to use the preferences to their advantage!

It is also worth noting that the complacency about PTAs not leading to trade diversion has also been aided by the notion that the external trade barriers are no longer very high and that, therefore, preferences could not lead to significant trade diversion away from the non-members. But this is not true for several reasons.

To begin with, even trade tariffs are still very high, both in developing and in developed countries. In the latter, the Uruguay Round has still left several peak tariffs in specific products, whereas the tariffication of agricultural support has created truly substantial tariffs. In the developing world, countries in South Asia and in Latin America are also not free from high trade barriers, making PTAs particularly dangerous.

Besides, the external trade barriers are today only a part of the protectionist story. "Administered protection," consisting of instruments such as anti-dumping (AD) actions, has become the favored policy of protectionists who cleverly use the appealing notion of "fair trade" to unfairly gain protection and advantage against successful foreign rivals. But then these instruments typically yield protection that is elastic and selective. Thus, AD duties, which bear little relationship to "predation" in the economic sense and hence have in practice no economic justification, are often based on adjusted prices that are estimated in ways calculated to fund dumping or on inherently arbitrary "reconstructed costs"; the AD methodology compares not foreign
and domestic prices, but foreign costs and domestic prices. Thus, within broad margins, it is arguable that AD calculations and actions will seek to accommodate the needs of the protectionist petitioners in the spirit of the story where the interviewing commissar asks candidates what the sum of two and two is, and the job goes to the candidate who answers: Whatever you want, sir. In addition to their being, therefore, elastic, AD actions are selective in the sense that they are mounted against specific countries and even specific firms within those countries. Thus, it is possible to use them to zero in against your most potent foreign rivals.

It follows then that, when internal competition among members breaks out, the temptation on the part of PTA members will be to protect each other with administered protection at the expense of non-members, unless such protection is severely regulated. In short, protection against non-members then becomes endogenous to the PTA. The consequence is that, as trade creation occurs within a preferential-trade agreement such as NAFTA, the endogenous raising of protection converts it into trade diversion instead. For example, as Mexico starts crowding out inefficient U.S. producers, the United States accommodates imports from Mexico by reducing imports from the most efficient non-member supplier, Taiwan, using AD actions against Taiwan.

Such a phenomenon is not an idle theoretical speculation. Important instances of such endogenous raising of protection against non-members have been observed. An example is the raising of tariffs on more than 500 non-NAFTA tariffs by Mexico during the 1995 peso crisis while the Mexican tariffs on NAFTA items remained on the downward path. The former could be raised because Mexico had bound tariffs above existing levels at the WTO; and it could be argued that the reason for taking such weak bindings was precisely that, with NAFTA, Mexico wanted to hold on to the freedom to raise some tariffs if deemed necessary, implying that the potential for trade diversion was implicitly built into the NAFTA treaty. Thus, Treasury Secretary Robert Rubin, in claiming (as does the DRI report) that, unlike 1982, NAFTA had made Mexico abstain from the use of trade restrictions to deal with the 1995 peso crisis, was wrong on two counts. Mexico did raise some tariffs, but on other countries and not on us, whereas Mexico has been no different from others in its policy reaction to a currency crisis: Trade restrictions as the knee-jerk, big-bang response to them are generally not seen as appropriate, whether a country has an FTA or not.

The French economist Patrick Messerlin has also written of the effect the EU association agreements, leading toward eventual entry into the EU, had on the Central European countries' acceptance of obligations at the WTO. These nations, coming from the collapse of communism and the absence of significant protectionist lobbies in their midst, had embraced a strong policy of MFN-based trade liberalization. At the insistence of the EU, which was interested in getting preferred access to these markets, the eventual acceptance of WTO obligations by these countries was marked by a raising of their MFN tariffs!

The “Spaghetti-Bowl” Phenomenon: But if individual PTAs are flawed in this way, they have raised added concerns because of the "systemic" implications when many PTAs have emerged on the scene, as they have since the 1980s. These systemic implications arise because such preferential-trade agreements magnify the problems that arise, in essence, because we try to restrict or liberalize trade on the basis of which product comes from which country, or what I have called the "who is whose" problem. Thus, for instance, as soon as the United States wishes to liberalize preferentially the imports from Israel, it must decide whether an import coming from Israel is Israeli—i.e., it must establish a "rule of origin," which usually takes the form of some sort of "content" rule, such that a product is considered to be Israeli only if its Israeli content exceeds an arbitrarily specified share in gross value.

The arbitrariness of this share specification is further compounded by the arbitrariness inherent in computing such content. Thus, consider the import of steel ingots that, in conjunction with homogeneous domestically produced ingots, go into producing scissors and forks. How is one to determine which of these two products got what share of the imported as against the domestic ingots? Again, if forks need to be coated with plastics, we know that even if the plastics are immediately produced at home, their gross value would generally include imported intermediates at several stages of manufacture, which are impossible, for the same reasons, to identify and quantify meaningfully. Again, even if we were to estimate such imported shares meaningfully, the imports are likely in turn to include, in today's globalized production, intermediates produced by us and used by the producers abroad. The difficulties are myriad, even endless.

All of these problems, which inherently lead to absurd arbitrariness in trying to identify the origin of products, are particularly acute with an FTA where the different
external tariffs inevitably require that the origin be established for virtually all traded products. In FTAs, the fear of non-member goods coming into one’s territory at a lower tariff than one’s own, simply by entering through another lower tariff member country, is palpable.

In reality, FTAs have created yet further problems by having many different rules of origin, varying by products (as in NAFTA, for instance) and by FTAs (when, say, the EU has FTAs with different rules with several different non-EU countries). The problems inherently posed by the rules of origin are further compounded since FTAs are on different schedules of tariff-cutting by sector and are not synchronized (having been negotiated at different points of time and with different schedules for reaching zero tariff outcomes), so that we typically find a large and chaotic set of applicable tariffs on the same good, depending on the source to which the good is assigned.

The result is what I have called the “spaghetti-bowl” phenomenon of numerous and crisscrossing PTAs and innumerable applicable tariff rates arbitrarily determined and often depending on a multiplicity of sources of origin. In short, the systemic effect is to generate a world of preferences, with all its well-known consequences, which increases transaction costs and facilitates protectionism. In the guise of freeing trade, PTAs have managed to recreate the preferences-ridden world of the 1930s as surely as protectionism did at the time. Irony, indeed!

And thus in the debates on GATT, international economists who have been either ambiguous or complacent in regard to PTAs have acquired a proper appreciation of Keynes’s famous words in the House of Lords, extolling the virtues of multilateral MFN-based trade and rejecting the preferences he had earlier defended. The separate blocs and all the friction and loss of friendship they must bring with them are expedients to which one may be driven in a hostile world where trade has ceased over wide areas to be cooperative and peaceful and where are forgotten the healthy rules of mutual advantage and equal treatment. It is surely crazy to prefer that.

**Two Qualifiers**

Crazy to prefer PTAs, yes. But still, there are two circumstances where a staunch anti-PTA, multilateral free trader would make an exception.

First, if the PTA takes the form of deep integration in the form of an EU-core style Common Market, with common external tariff and internal factor mobility, and possibly even a parliament and attempts at a unified foreign policy, then the member nations are forming something close to the federal United States or India. In this case, the trade dimension cannot be judged in isolation from a very much bigger picture. Indeed, the overriding political need to counteract the nascent Soviet threat with a politically united Europe and the fact that the treaty would aim at deep economic integration in Europe and not just trade preferences the way an FTA does, were the reasons for the benign and supportive U.S. attitude to the 1957 Treaty of Rome. This is true even though our view of PTAs was quite clearly hostile, as it had been about Britain’s Imperial Preference during the GATT negotiations and had indeed been throughout our two-centuries’ history. Anyone familiar with George Washington’s Farewell Address or with Woodrow Wilson’s Fourteen Points will recall that this is so.4

Second, there is what international economists now call the “dynamic time path” justification for PTAs. This has to do with the possibility that, even though we seek worldwide multilateral free trade, multilateral trade negotiations (MTN) at the GATT, now the WTO, may not be the way to get there. We thus need to distinguish between “process multilateralism” and “outcome multilateralism.”

The fact remains that the United States, faced in November 1991 with opposition by the EU and many developing countries to the declaration of another MTN Round to follow the Tokyo Round, felt that it had no option except to shift to PTAs, legitimate under GATT’s Article XXIV, as a way of keeping trade liberalization going. Hence came the initiative under U.S. Trade Representative Bill Brock for CUFTA between Canada and the United States, the first break in our policy of undivided loyalty to MFN multilateralism. It is important to recall that the motive, contrary to what it became later, was not regionalism in the Americas. The motive, rather, was purely that of trade liberalization; and the intention was to expand the FTA in any direction, whether in our region or elsewhere. Bill Brock is regarded as having seriously considered adding Egypt and the ASEAN countries but found no takers. We can be certain that if life had been found on the moon, and a government to negotiate with, Brock would have hawked an FTA to it as well.

This second reason for FTAs then is simply that, if MTN is not working to liberalize trade worldwide, we will
take the PTA route to freeing trade worldwide, inefficient as PTAs can be en route. In short, if the turnpike is not open, we take the dirt road.

**No Excuse Now for PTAs by the United States**

There is really no reason now for us to keep going on the dirt road. The turnpike is open. The Uruguay Round concluded successfully. GATT, pronounced by the summarily skeptical Lester Thurow to be dead, did die but joined the blessed twice-born, appearing as the much strengthened and institutionalized WTO. The unfinished business of the Round, set on the negotiating agenda, has also been producing results: the telecommunication pact, the information technology agreement, and pretty soon, without doubt, there will be a multilateral agreement on financial services. These multilateral agreements happen to be backed by strong export lobbies that will profit from them, and they have no countervailing import-competing lobbies arrayed against them. So, in fact, the renewal of fast-track to get them through Congress is not necessary. Indeed, unless one goes for a new MTN Round, which the Clinton administration has not committed itself to, there seems to be no compelling reason to immediately renew fast track legislation as far as multilateral trade treaties are concerned.

There is also little evidence for the argument, often advanced, that we should go for both MTNs and PTAs because the latter will help the former move forward. Fred Bergsten argues that the Seattle summit of APEC moved the EU into settling the Uruguay Round by threatening Europe with an American trade alternative of regionalism that would exclude it from the trade game. But this is fanciful since there are plenty of indications that the EU was about to settle anyway; besides, we made the key trade concession—in agriculture—which finally broke the logjam. Equally, APEC is cited as having led to the information-technology agreement three weeks before the first WTO ministerial meeting in Singapore; but this is nothing but a "post-hoc-ergo-propter-hoc" fallacy. Our intensive work would have produced the agreement at Singapore even if there had been no APEC, for sure. Besides, APEC is a "regional" arrangement but is not a PTA.

On the other hand, there are disturbing examples of how PTAs have undermined the multilateral liberalization process instead, by holding up concessions by countries on an MFN basis because partner countries, especially hegemonic ones, in the PTA look for and get preferred access—as in the case of NAFTA and, more important, Central European countries that were already cited. Again, Sebastian Edwards of UCLA, who was the World Bank's Chief Economist for Latin America, recently argued in *The Wall Street Journal* that Chile's progress toward MFN liberalization had slowed down as a result of the different regional PTAs it was getting involved in. Thus, to those who say cyclicly that we will do well by following a "GATT plus" approach, using PTAs alongside multilateralism, I say: It is likely to work as well as the "marriage plus" approach worked with Demi Moore in the film, *Indecent Proposal*.

**What about Regionalism for the Americas?**

So, clearly there is no good case for us today to be pursuing trade liberalization through the NAFTA extension and through other FTAs. Indeed, FTAA remains at the moment the only "big-ticket" item on the PTA agenda with a possible political future.

Thus, the Asian members of APEC have refused to date to turn it into an Article XXIV-sanctioned FTA despite our clear desire in that direction. Instead, they have insisted on undertaking trade liberalization under APEC auspices only on an MFN basis. Partly this is because the successful Asian exporters have never wanted to go regional or subregional in trade; the whole world was their market. Partly, the politics of it would be absurd for them since an FTA would then exclude the EU, and hence the previous colonial powers with whom many Asian countries have a special relationship. Just imagine President Salinas entering into an FTA that excluded the United States. Then again, the Trans-Atlantic Free-Trade Area (TAFTA), floated by Foreign Minister Klaus Kinkel of Germany and embraced by the Atlanticist Foreign Minister Michael Rifkind in Prime Minister Major's government, has given way now to a non-FTA transatlantic initiative.

In fact, a few weeks ago the European Council of Ministers, responding to the growing concerns about the proliferation of PTAs and its own role in creating this problem, resolved that the "current architecture" of its trading system would be frozen. In practice, it means that no new PTA initiatives will be undertaken without far more acute examination and skepticism than was the case to date. The WTO also has an active Committee on Regionalism whose task it is to analyze the working of Article XXIV in light of the growing tide of skepticism about PTAs.
One would think that the Clinton administration would take heed as well and desist from further indulgence of FTAs, reverting instead to multilateral trade initiatives. But it has not. Part of the reason, of course, is intellectual laziness. Partly it is also the fact that no international economists of repute have ever had access to the White House, where the main concern has been the politics of its trade policies, not their economics. Then again, there is the inertia of past decisions: The FTAA is in effect the legacy of the Baker transformation of the open, non-regional FTA initiative into a closed, regional initiative for the Americas.

Matching the American folly is much of South America’s own misguided enthusiasm for the FTAA. It is remarkable that this continent, so rich in its literature, has been so deficient in its trade policy in the postwar period, having successively succumbed to the destructive strategy of import substitution, then fallen for the Generalized System of Preferences for developing countries, which many economists today believe to have been a mistake, and who are now enamored of the PTAs. It is sad to see the huge enthusiasm for free trade that has finally broken out there being channeled not into the multilateral freeing of trade, but into the politics and economics of PTAs.

The South American enthusiasm is largely responsive to our own, seeing access to our markets as the gain they get from our preferred access to theirs. It also reflects the sense of solidarity, as against hostility, that is now more manifest in these countries toward us. “Regionalism” is then seen as a cementing bond, a glue to launch joint efforts for human rights, democracy, et al., in the Americas. It must also be recognized that the politics of PTAs in the Americas is also divisive and sidetracks free-trade sentiments into unproductive politics. This is true of the well-known rivalry between NAFTA and Mercosur as the leading lights of the trade-liberalizing movement in the Americas. Brazil, the dominant player in South America, sees NAFTA extension into FTAA as a hegemonic extension by the United States, and Mercosur is, at least in part, in a response to NAFTA. The creation of APEC with U.S. initiative was, of course, in part a geopolitical response to the Mahathir Asian bloc initiative, which, in turn, was a response to our NAFTA. And so, with PTAs, politics tends to hijack and distort the freeing of trade, whereas the multilateral system tends to narrow it down to its economics—and permits more focused attention to the free-trade objective.

An Alternative for the Americas: Return to Camelot

The policy option for the United States is entirely clear. We should revert to exclusive focus on multilateralism and MFN-based trade liberalization, asking the South American nations to join in the multilateral opening of markets through a variety of initiatives, while pursuing “regionalism” and its separate objectives through non-PTA means. In short, we should renounce the FTAA gracefully, easing into an Americas Initiative that focuses, like APEC, on issues like security, democracy, human rights, drug trafficking, customs procedures, and a whole host of issues of hemispheric interest, while becoming a regional platform for launching multilateral trade liberalization initiatives.

This is, in fact, the policy framework that President Kennedy had when he stayed loyal to non-discrimination in trade, eschewing our use of Article XXIV-sanctioned PTAs while launching the Alliance for Progress for South America for several non-trade objectives. Thus, in pursuing free trade through non-discriminatory trade liberalization and regionalism through the Alliance for Progress, he implicitly understood the chief lesson of policymaking—that two objectives are usually achieved best with the use of two policy instruments. As our forefathers put it, one cannot (generally) kill two birds with one stone. It is surely not too late to return to Camelot.

Eliminating Preferences

On the general question of PTAs, some would even like to roll back existing PTAs to rid the world trading system of this pox. That is utopian, but a standstill, a freeze, is more doable. There is, however, a simple solution to ridding the world of the preferences that existing PTAs burden us with. Since preferences relative to zero are zero, one can effectively eliminate them also by reducing the MFN tariffs down to zero. Hence, many economists have allied themselves to the goal that Martin Wolf of The Financial Times first proposed for the trading nations to announce: that, by a date such as 2025, the world be rid of all border trade barriers.

So far, the U.S. administration has poured cold water on the idea, arguing that concrete trade pacts are necessary, not a vision. That is like saying that it is enough to go around filling potholes as one finds them, that a road map is unnecessary. But then what can one expect from an administration where trade policy is run by politicians
watching the polls, and where lawyers, with their adversarial mentality, implement it?

Notes
1. Mercosur is a customs union (CU), which is different from an FTA, because it also has a common external tariff. A common market is additionally characterized by free mobility of capital and labor among the members. All are PTAs.
2. The U.S.-Israel FTA does not have any value as a precedent and signifies no change in trade policy since it was dictated purely by the politics of our "special relationship."

Palmeter, a distinguished trade lawyer, also expresses astonishment at the fact that "there has been virtually no debate—vigorous or otherwise—on the current retreat from the United States's historic commitment to nondiscriminatory multilateralism" (page 993). Of course, he means a public debate; within scholarly circles in the universities, there has indeed been a vigorous debate where I have witnessed an increasing hostility to PTAs emerge in the last few years, when there was really little when I started writing in 1991.
The New Face of Regional Integration

ENRIQUE V. IGLESIAS

Regional economic integration has played an important role in Latin America and the Caribbean's postwar economic history. The 1960s and 1970s saw a number of ambitious initiatives inspired by the optimism surrounding the successful Western European experience. There was the formation of the Central American Common Market (CACM), the Caribbean Free Trade Association and later Caribbean Community (CARICOM), the Latin American Free Trade Association and subsequent Latin American Integration Association (ALADI), and the Andean Group. At its peak in the late 1960s and early 1970s, the topic of integration was indeed hard to avoid in the discussion of Latin American and Caribbean development. However, some serious disillusionment had clearly set in by the late 1970s, and by the early 1980s discussion of regional integration was nearly silenced by the overwhelming attention required by the external debt problem, adjustment and national crisis management.

I imagine that by the mid-1980s many of the region's experts on integration had begun to look for new areas of employment. The topic of integration suddenly re-emerged, however, stimulated in part by developments in an unexpected place: North America. In the late 1980s, the United States, formerly skeptical of regional integration, launched an agreement with Canada, which later incorporated Mexico through NAFTA.

The decade of the 1990s has witnessed a wave of regional integration initiatives in Latin America and the Caribbean (14 major agreements—free-trade areas or customs unions—since 1990, with a handful more in varying degrees of negotiation). However, this was not just a phenomenon of Latin America and the Caribbean—regionalism has more than ever become a global phenomenon. Indeed, nearly all World Trade Organization (WTO) members are now signatories of at least one preferential-trade agreement.

We also must not lose sight of the fact that the renewed interest in regionalism in Latin America and the Caribbean has parallel unprecedented structural economic reforms, including dramatic unilateral trade liberalization and a process of implementing the most ambitious multilateral round of trade liberalization in history. Thus, my remarks about regional integration in Latin America and the Caribbean will be couched in terms of broader trade issues and the overall process of policy change in the region. I also want to discuss the role of my institution, the Inter-American Development Bank.

The Growth in Trade

General Trends
The 1990s have witnessed a rebound in the region's trade after the crisis of the previous decade. Between 1990 and 1996, the region's exports expanded by 76 percent;
imports grew even faster, at 127 percent. Total trade as a percentage of the region’s GDP now equals 36 percent, up from 24 percent in 1990, a clear indication of increased trade openness. Moreover, throughout the 1990s growth in the region’s trade has consistently exceeded that recorded at the world level: According to WTO estimates, the value of world exports and imports grew by an average 7 percent a year between 1990 and 1996 (compared with 10 and 16 percent for Latin American exports and imports, respectively). Consequently, the region’s share in world trade has expanded, from 4 percent in 1990 to 5 percent in 1996. A closer look at the region’s trade performance in the 1990s reveals the following trends:

- Intra-regional trade has grown more rapidly than trade with countries outside the region. This trend is particularly pronounced in the case of exports. Since 1990, the value of intra-regional exports has grown by 18 percent a year on average, compared with 9 percent growth in extra-regional exports. Intra-regional exports now account for 18 percent of total Latin American and Caribbean exports, up from 12 percent in 1990.

- Growth rates for intra- and extra-regional imports have been more homogeneous. While intra-regional imports expanded by an average 18 percent a year between 1990 and 1996, extra-regional imports also grew very fast, by 14 percent a year, reflecting a generalized import boom in the region. The share of imports originating from intra-regional sources has grown from 15 percent of total imports in 1990 to 18 percent in 1996.

- The marked difference in the growth rates of the region’s overall exports and imports (76 percent and 127 percent, respectively) reflects a large imbalance in the growth of trade with extra-regional markets, with imports from these sources expanding nearly twice as fast as exports to extra-regional destinations.

Several factors seem to be contributing to these trends. I say “seem” because, as I will discuss a bit later, much more empirical work still needs to be done in evaluating the factors behind growing commercial links in the region.

Geography. Neighboring areas dense in capital and population tend to interact and trade. This tendency can be enhanced further when income levels, cultures, tastes and languages are similar as they are in Latin America and when significant differentials exist in transport costs between contiguous and non-contiguous countries. In fact the boom in intra-regional trade has largely been among neighboring countries in the region.

Relaxation of the external restriction. The decline of world interest rates, debt relief and a return of external capital flows in the 1990s has dramatically raised import capacity in the region. Imports have sharply risen across-the-board. Since intra-regional imports equal intra-regional exports, the import boom has been reflected in the marked growth of intra-regional exports.

Real exchange-rate appreciation. The region’s external trade performance has also been influenced by the exchange-rate behavior of Latin American and Caribbean countries. The use of exchange-rate anchors in support of stabilization programs, as well as significant inflows of foreign capital in the early 1990s, have contributed to real currency appreciations in an important number of countries. This has tended to encourage imports while, at the same time, posing problems for some of the region’s exports.

Economic reforms. The structural reforms undertaken in the late 1980s and 1990s have energized private-market activity, investment and trade. Unilateral liberalization has been a key in exposing natural market opportunities for exports to neighboring countries that heretofore were hidden behind the wall of protectionist policies.

Subregional Trade Agreements. The aforementioned explosion of subregional and bilateral trade agreements in the 1990s has stimulated intra-regional trade in many ways—for example, by:

- signaling to the private sector the permanence and deepening of public commitments to liberalization. In some agreements (such as Mercosur), the additional commitment to trade liberalization is accompanied by a broader political message pursued at the highest official levels to promote peace and non-economic cooperation among member countries.

- giving the private sector legally binding market access, which has reduced the risks of trade and investment, in contrast to unilateral opening.

- providing the preferences that are part of the agreements. It is important to point out that some of the preferences (e.g., ALADI’s) in fact predate the new trade agreements of the 1990s and have been eroded by the unilateral liberalization of trade.

With the progressive stabilization of domestic price structures in Latin America, there are now signs that the
The aforementioned process of currency appreciation may be reaching a plateau. This, coupled with possible further productivity gains resulting from structural reforms and new investment, could favor stronger export growth in the coming years and thus facilitate a more balanced overall trade performance vis-à-vis extra-regional markets. Meanwhile, the one-off effects of initial liberalization efforts in recent bilateral and subregional trade accords are increasingly being realized. Future growth in intra-regional trade, therefore, will depend on continued deepening of liberalization commitments among Latin American and Caribbean countries, and more effective exploitation of natural trading opportunities in the region through measures such as the improvement of the network of regional infrastructure.

Current Trends at the Regional and Subregional Levels

In 1996, the value of the region's total exports expanded by 11 percent; imports grew by the same rate. This compares with growth rates of 21 percent and 10 percent, respectively, in 1995. Slower export growth in 1996 relative to the previous year affected all subregions and was mainly a result of stagnant or declining world prices for some basic commodities, although oil-exporting countries benefited from a sharp rise in petroleum prices, and some countries were able to counterbalance unfavorable commodity price trends with an increase in export volume. In fact, in 1996, the volume of exports expanded at a rate very similar to that of the previous year (10 percent, compared with 11 percent in 1995).

As for import growth in 1996, it was due almost entirely to increased volume. Import growth slowed markedly in five of the region's major economies (Brazil, Chile, Colombia, Peru and Venezuela), while Argentina and Mexico saw a rebound in imports after recovery in their domestic economies.

In 1996, for the first time since 1990, the region's intra-regional exports grew at a slower rate (7 percent) than exports to third markets (12 percent). Three subregions—the Central American Common Market, the Andean Group and the Group of Three (G-3)—followed this overall trend, while NAFTA and Mercosur did not. In all subregional markets except NAFTA, growth in intra-regional trade slowed markedly in 1996.

CACM. Intra-CACM exports expanded by just 5 percent in 1996, a growth rate much lower than the average for the 1990–95 period mainly due to a slowdown in trade between Guatemala and El Salvador. While intra-regional trade has expanded less rapidly than that of other integration groups in Latin America, such trade now accounts for roughly 20 percent of total CACM exports, up from 16 percent in 1990.

The Andean Group. After several years of rapid growth, intra-Andean trade stagnated in 1996, increasing by only 1.2 percent compared with 1995. A marked slowdown in the growth rate of Colombian exports and a sharp decline in Venezuelan exports to the subregion were the main factors behind this development. Although intra-Andean trade expanded by an average 29 percent a year between 1990 and 1995, such trade still accounts for only 11 percent of the subregion's total exports. However, for some countries (notably Colombia and Bolivia), the Andean market is of much greater significance. Moreover, if petroleum is excluded from total export figures, intra-Andean exports as a share of total exports represent 18 percent.

Group of Three. Trade among G-3 members declined by 2 percent in 1996, due to a slump in Venezuelan exports and a significant slowdown in the growth of Colombian and Mexican exports within this subregion. Due to the relative insignificance of Mexican exports to its G-3 partners compared with its overall exports, intra-group trade accounts for less than 3 percent of overall G-3 exports, although such exports have tripled in absolute value since 1990.

Mercosur. Mercosur also recorded a much slower growth in trade among its member countries in 1996: 12 percent, compared with over 20 percent in 1995. This is mainly explained by a sharp slowdown in the growth of Argentine exports to Brazil. As in previous years, however, intra-Mercosur trade again expanded at double the rate of the subregion's exports to third markets, and now accounts for 22 percent of total exports, up from 9 percent in 1990.

NAFTA. Intra-NAFTA exports expanded more rapidly than NAFTA's total exports, contrary to what had happened in 1995. One of the most notable developments in 1996 was the recovery of Mexican imports from the United States, following a sharp drop in 1995 as a result of the Mexican peso crisis. In 1996, Mexican imports from the United States grew by 24 percent, not only recovering but significantly exceeding their precrisis level of 1994. Since 1990, intra-NAFTA trade has expanded by almost 11 percent a year (faster than the 7 percent increase in NAFTA's
trade with third countries) and now accounts for almost 50 percent of total NAFTA exports. While most of intra-NAFTA trade happens bilaterally between the United States and Canada, and the United States and Mexico, respectively, Mexican-Canadian trade has increased sevenfold since 1990, albeit from a very low base.

**CARICOM.** In 1990–95, intra-CARICOM exports grew much faster (8 percent) than CARICOM exports to the rest of the world (5.5 percent). Like other subregions in the hemisphere, CARICOM countries thus seem to be taking increased advantage of regional export opportunities. Nevertheless, intra-CARICOM exchanges still represent only around 15 percent of the subregion’s exports, and are heavily dominated by the oil trade of one country, Trinidad and Tobago. In that sense, the small island economies have not yet reached an important degree of integration. It should be noted, however, that trade with neighboring countries of the Association of Caribbean States (ACS), while still modest, has increased rapidly in recent years, even faster than intra-CARICOM trade. (According to IMF data, CARICOM exports to these countries have grown by almost 16 percent a year since 1991.) ACS markets may, therefore, represent a potential area of new opportunities.

The rapid growth in intra-regional trade among Latin American and Caribbean countries in recent years, coupled with the dramatic increase in Mexican trade with its NAFTA partners, has meant that more than 70 percent of Latin American and Caribbean exports are now destined to markets within the Western Hemisphere, compared with around 60 percent in 1990. U.S. and Canadian share in the region’s overall exports has increased, but this is largely explained by their trade with Mexico. Throughout most of Central and South America, the United States and Canada have become relatively less important export destinations in recent years, although in absolute figures, trade with these countries has increased significantly. Meanwhile, the share of exports going to extra-hemispheric markets has declined for all Latin American and Caribbean subregions except Central America. From the U.S. viewpoint, the Latin American and Caribbean region has constituted a market of growing export opportunities; this is the case even when its rapidly expanding trade with Mexico is not considered. U.S. exports to non-NAFTA members in the hemisphere now account for 8.4 percent of the total U.S. exports, up from 6.5 percent in 1990.

The picture for imports is slightly different: Here, extra-hemispheric markets have increased their share as suppliers to the Latin American market. In 1995, almost 35 percent of the region’s imports were supplied by countries outside the hemisphere (mainly the European Union, Japan and the newly industrialized Asian countries), compared with a 33 percent share in 1990. It should be noted that, among the various subregions in Latin America and the Caribbean, Mercosur is the one least dependent on the North American market. In 1995, more than 50 percent of its trade was with extra-hemispheric markets.

Intra- and extra-regional exports from Latin America and the Caribbean display marked differences in terms of their product structure, with manufactures accounting for a much larger share of intra-regional commerce. This pattern is evident even if Mexico—whose maquila trade with the United States accounts for a large share of Latin America’s overall exports—is discounted from the regional average. Excluding Mexico, manufactures account for approximately 50 percent of intra-regional exchanges, compared with around 23 percent for extra-regional exports. In both cases, the share of manufactures in the total has expanded slightly since 1990, although for most countries of the region, extra-regional exports are still heavily dominated by basic commodities, and hence vulnerable to fluctuations in world commodity prices.

**Why the IDB Supports Regional Integration**

The Inter-American Development Bank (IDB) was created in 1959 with the specific mandate to promote regional integration and economic and social development in Latin America and the Caribbean. This dimension of regional integration is unique among development banks and has been one of the defining characteristics of the Bank. When shareholders added $40 billion to the Bank’s capital in 1994, the mandate to support “regional integration and modernization” was reaffirmed.

Why is the IDB especially disposed to support regional integration? One fundamental reason is the political values of many of its shareholders: Latin Americans share a common heritage, language and culture. There is a side of us Latin Americans that makes us want to be more together—sentiments extending back to Bolívar and independence. The phenomenon is sometimes hard for non-Latinos to understand and could seem contradictory given the long history of serious political disputes among Latin American
nations. But the fact remains that the centrifugal forces of disagreement have coexisted with, and often have been overcome by, the centripetal forces of a common heritage and culture. These opposite forces, of course, can be especially intense in the various geographic subregions of Latin America.

More to the point, however, regional integration is a subset of, and complement to, a phenomenon of integration of a much broader scope that is inherently part of the development process that the Bank supports.\(^1\) In effect, the dynamics of economic development induce the integration of markets, regions and people. The larger markets and competition brought on by this process enhance specialization, efficiency and growth with corresponding welfare gains.

Even though processes of integration are a natural part of growing market economies, this development can be blocked by political, institutional and economic barriers. The Bank’s programs in support of development and economic integration are designed to help countries overcome these barriers.

The task of the Bank has been greatly facilitated by the dramatic shift in the 1980s regarding development in Latin America, away from state-dominated and protected economies, and toward open, private market-driven regimes. Indeed, nearly all the countries of the region have undergone a profound process of structural economic reforms. The IDB has been actively supporting this process, and, of course, our host, the World Bank, as well as the International Monetary Fund, have been at the forefront in providing support for reforms not only in Latin America but throughout the developing world.

The reform process in Latin America’s economies has energized markets and entrepreneurial activity and naturally increased the region’s interaction with the world economy. It also has induced spontaneous regional market integration, which, as mentioned, explains in part the growth of intra-regional trade.

The IDB is supporting deliberate regional integration initiatives in the broader context of its support for the process of structural economic reform. In the initial stages of their development, regional integration arrangements link up with the overall reform process, most obviously through the trade-liberalization component. In effect, we view regional integration as a third tier of a three-tier liberalization process.

- The first and most important level of liberalization has been through unilateral measures to open up economies. During the late 1980s and early 1990s practically all countries of the region moved to reduce trade barriers. This effort is reflected in the fact that the average tariff in Latin America and the Caribbean has declined from 45 percent in the second half of the 1980s to 13 percent in 1995, accompanied by a sharp reduction of tariff dispersion as well. Furthermore, over the same period the share of the region’s imports subject to non-tariff barriers has declined from 31 percent to 11 percent. Specific tariffs have virtually disappeared even while they are still common in the industrialized economies. I think most will admit that this truly has been an impressive transformation.
- The second level of external opening is multilateral. The region was a very active participant in the Uruguay Round, and assumed the new disciplines that emerged from this exercise. It was the only developing region to bind 100 percent of its tariffs. With Panama joining the WTO in 1995, all of the region is now subject to the rights and obligations of this world organization.
- The third tier of opening is through regional integration. It is often overlooked that in the new context of policy change in Latin America, regional integration is an additional instrument to open economies to competition and complements levels one and two of the trade-liberalization process. Indeed, it is the broader commitment to general economic liberalization that is one of the major driving forces behind the recent spurt of regional integration initiatives in the 1990s and helps give the processes the character of “open regionalism.”

This, of course, was not always the case. In the first decades after World War II, Latin America and the Caribbean pursued a number of ambitious economic integration initiatives. However, the regional integration of that era inserted itself into the prevailing development strategy of import substitution that worked so well in the interwar period and in the 1950s, but that had been exhausting itself in the face of the postwar renewal of private market activity, liberalization and the initiation of the postwar phase of globalization. Indeed, the integration schemes of the period were designed in part to rescue the import substitution model through a strategic and selec-
tive expansion of a highly protected market. While the integration initiatives achieved some important results—for example, the significant liberalization of trade in Central America—outcomes fell far short of objectives. On the one hand, the strong national political commitments to domestic protection made opening up even among associate countries a very laborious negotiating process that rarely achieved more than very partial results. On the other hand, the costs of trade diversion were amplified due to the general presence of extraordinarily high and sometimes increasing barriers to third parties.

The traditional model of development in the region changed in the 1980s, and this, in turn, has dramatically changed the face of regional integration itself. The regional integration of today has inserted itself into the broader overall strategy of opening up to the world economy. Not surprisingly, the new subregional integration initiatives have mirrored the relatively aggressive tone of the overall opening-up strategy observed in the region. Countries have entered into multiple arrangements that are eliminating tariffs among partners in substantially all trade within 10 to 15 years and often involve other commitments that even go beyond the WTO's trade-related disciplines.

**Some Expected Benefits of Regional Integration**

Without being exhaustive, here are some of the positive (and interrelated) impacts on development that we hope to derive from regional integration initiatives:

- The introduction of a lowering of the average level of protection vis-à-vis the status quo, which raises competition and promotes specialization in the subregional market. This could be done through further unilateral opening, too. However, in certain conjunctures authorities can find that a partial opening in a subregional arrangement can meet less political resistance (and even be relatively popular as in the case of Mercosur). This may be because of a number of associated factors such as public sentiments about "getting together" with a well-defined neighbor, reciprocity with guaranteed market access, and more limited impacts on fiscal income.

- The expansion of market size to facilitate greater specialization and industrialization through economies of scale and possibilities to exploit economies associated with the forces of location and the agglomeration of production activity.

- New domestic investment and foreign investment, both of which are channels for the transfer of new technology, enhanced international competitiveness and global economic convergence, brought about by the forces of competition and the larger market with guaranteed access.

- The emergence of new exporters of manufactured goods because of the security of subregional market access, preferences and the familiarity of neighborhoods. The learning curve associated with subregional export experience—which, as we saw, heavily involves manufactured goods—can serve as a platform for new international exports. This is an important consideration, because history has shown that developing countries can achieve new dynamic comparative advantage on the road of their long-term convergence with industrialized countries.

- Authorities' commitment to liberalizing policies signaled by a regional arrangement, and locked-in commitments that otherwise are more easily reversible. North-South agreements in particular are often cited for these confidence-building effects. A good example is the incorporation of southern Europe into the European Union. NAFTA may similarly serve Mexico, and we expect that the FTAA will also contribute to locking in more mature trade and investment policies in Latin America.

- Increasing confidence from the enhanced international competitiveness brought about by regional integration, which also should prepare countries for further advances in unilateral and multilateral liberalization. In this latter case, regional integration can also be viewed as a way to move ahead with liberalization while the region awaits consensus on development of a new round of reciprocal disciplines.

All these aspects of regional integration are, of course, potential developments rather than guaranteed outcomes; what happens in practice depends on the nature of policy implementation, a point I will return to. Moreover, the distribution of these impacts will, unless compensation mechanisms are available, tend to be uneven among partners.

**Some Expected Costs of Regional Integration**

The potentially positive aspects of regional integration are accompanied by costs, too. These are frequently cited costs:
• Preferences in regional trading arrangements can divert trade away from possibly more efficient firms that are located in non-member countries. This has costs for consumers in the partner economies and for the non-member countries that lose market share. The trade diversion risks locking the country into patterns of inefficient production.

• Regional integration agreements can improve the terms of trade of member countries at the expense of non-member countries, and give rise to incentives for maintaining or increasing preferences and protection.

• When there are serious asymmetries in average tariff levels among prospective partners of an integration agreement, the loss of tariff revenue in the liberalization process can have serious redistributive effects among the countries.

• Successful integration could, under some assumptions of opportunistic behavior, discourage or delay interest in unilateral and multilateral liberalization.

Putting Costs and Benefits into Perspective

There is no doubt that integration has costs. For instance, some trade diversion is inevitable, and the initial redistributive effects from lost tariff revenue can be important, especially in North-South agreements like NAFTA and the prospective Free-Trade Area of the Americas (FTAA). But we all know that any process of economic transformation, or reform, has costs, and these costs are typically disproportionately concentrated up front. The costs, however, are justified by the greater benefits that are expected, but these are typically spread out over a longer period of time. An integration scheme is clearly a long-term project in which countries accept short-term costs in order to capture some of the long-term dynamic benefits outlined above.

Many of the recent critiques of integration have especially focused on the trade diversion issue. It is certainly important to be vigilant about the costs involved in regional integration. But to cast one’s vote against a new regional integration initiative due to risks of trade diversion is probably overly rash. Judgment should await the evaluation of the direct development impact which is a medium- to long-term general equilibrium phenomenon that is admittedly not easy to untangle. In any event, it is only with the emergence of the longer-term dynamic impacts on growth and development that one can judge whether the initial costs were worth it for the country and for the world community at large.

A case in point is Mercosur. This agreement is barely five years old, and still only in the initial stages of formation. Nevertheless, it has already been under siege as a threat to itself and the world for allegedly being a hotbed of trade diversion that is creating a “fortress Mercosur.” The fact of the matter is that the subregion has never in its recent history been so open to world trade. Due to unilateral liberalization, average external tariffs on manufactures have fallen from 25 percent in 1990 to 12 percent in 1995. This, coupled with the program of internal elimination of tariffs, has created more competition in these economies than they have seen in more than 60 years. The opening has contributed to a surge of imports across the board (a rise of 22 percent per annum since 1990), new investments and important gains in productivity. While imports from Mercosur partners have modestly increased their relative share of total imports, shares have also risen for most of Mercosur’s external partners. Moreover, a preliminary examination by the IDB’s Integration, Trade and Hemispheric Issues Division of shifts in intra- and extra-Mercosur participation in total imports at the three-digit standard international trade classification (SITC) level between 1990 and 1995, found significant trade diversion in only one sector (petroleum) and about 15 percent of the product categories. Indeed, the overall picture is indicative of considerable trade creation.²

Mercosur is young and suffers from many start-up problems that concern the IDB. But we certainly see the glass more as half-full than as half-empty. Indeed, it is our view that so far Mercosur has been a major catalyst of modernization in the subregion that has been characterized by serious political conflict, closed economies and fears of liberalization with each other and the rest of the world. The Bank is committed to encouraging Mercosur—and other integration agreements in Latin America and the Caribbean—to evolve in a way that maximizes the benefits for development and minimizes the costs to itself and the rest of the world.

Future Challenges and the Role of the IDB

The Bank’s programs in support of regional integration work on multiple fronts in an attempt to help its member countries overcome what it views to be the major challenges in the development of welfare-enhancing arrangements in the region. Typically, our strategies of assistance for integration aim to encourage a policy of open regionalism, which minimizes the risks of unacceptable costs and
amplifies potential benefits. Some of the major challenges that must be confronted are:

1. Progressive elimination of imperfections in subregional integration schemes, including:
   - Working to ensure full implementation of agreements and effective enforcement.
   - Developing politically feasible formulas to eliminate remaining exceptions to agreed trade liberalization. This is difficult but often worth the effort because the opening up of sensitive sectors is usually very rich in trade-creation effects.
   - Identifying and eliminating or harmonizing the numerous non-tariff measures still blocking intra-regional trade.
   - Liberalizing services—an important new area for attention. Fortunately, services are on the agenda of a number of agreements in the region. The Bank already has a program in place to support liberalization of services in Central America.
   - Dealing with cumbersome and sectorally restrictive rules of origin, which are present in some of the region’s agreements. Simplification is certainly possible through more exclusive reliance on tariff-shift criteria. Restrictive sectoral criteria should be gradually relaxed. The IDB is actively helping countries to empirically evaluate the impact of different types of rules of origin on their trade, and the Bank hopes multilateral talks in the WTO will provide insights on how to improve these regimes.
   - Promoting the development of modern trade disciplines in integration agreements, which are WTO-consistent or WTO-plus. Of particular concern is dispute settlement. When states dominated the economies of the region, it was perhaps effective to resolve commercial disputes diplomatically (the tradition in the region). However, now that private markets are the driving force of the economy it is necessary to make integration arrangements transparently rule-based: Only in this way will the member countries encourage the investment that is so important for the efficient specialization that is at the heart of successful integration agreements.
   - Rationalizing regional institutions. In the case of traditional integration schemes which modeled themselves after Europe, the task is to downsize an overdimensioned and underfinanced institutional structure. For the new schemes of the 1990s the task is just the opposite: to fortify incipient institutional arrangements so that instruments are compatible with objectives. The Bank has programs in the region that are working in both of these directions.
   - Creating effective mechanisms for the coordination of regional infrastructure networks that allow the private sector to fully exploit the natural advantages of location and mobilize financing, including an enabling environment to allow for private sector participation.
   - Participating in infrastructure projects. This is an area where the Bank has been very active. In 1990–96 the Bank lent more than $11 billion to the public sector for infrastructure projects. The Bank is also now supporting private investment. For example, our Private Sector Department has organized more than $700 million of Bank loans and guarantees for the finance of infrastructure projects worth more than $2 billion. Bank financing of infrastructure in our host area of Mercosur was $4.5 billion over the same period, and an additional $4 billion of loans are programmed.
   - Supporting the private sector’s participation in trade and investment, especially small- and medium-sized enterprises, which generate much employment but are not always fully equipped to take full advantage of regional integration. The Bank has active programs in support of these enterprises in integration processes and indeed is now in the process of supporting a second phase of a project in Mercosur.
   - Improving official mechanisms for the interchange of information and analysis on macroeconomic developments in the subregions and monitoring processes of convergence.
   - Developing effective ways to monitor the distribution of benefits within integration schemes and to create collective mechanisms to correct politically sensitive and potentially destabilizing imbalances. The Bank is helping subregional agreements to confront these issues and is also supporting initiatives to help the smaller economies in the FTAA process.

2. Consolidation and deepening of structural economic reforms—including unilateral trade liberalization—which have been underlying the success of intra-regional trade
and the progressive improvement of international competitiveness. The Bank is actively supporting developments in this area through national lending programs.

Continued gradual opening of the economies to the world is central to the process. While there has been much progress in unilateral liberalization, the average tariff level of 13 percent in the region is still high. External tariffs (and hence preferences in integration schemes) should be gradually reduced for efficiency reasons and for maintaining international legitimacy for open regionalism. Fiscal reform is needed to compensate for lost tariff revenue, to generate public savings for infrastructure development and to assist in long-term macroeconomic stability. Enhanced social services are essential for the human capital required to compete internationally and to ensure that the gains from trade are distributed more equally.

The region must develop more direct instruments to deal with fiscal disequilibriums and stabilization problems. Some recent disruptions in the trade-liberalization process do not reflect a reversal of commitments to open regionalism but rather "over-committed" policy instruments that have induced countries to confront fiscal and balance-of-payments disequilibriums with temporary increases in tariffs and non-tariff barriers. This has unfortunately distorted trade regimes that have previously undergone valuable reforms. With the development of more direct instruments for domestic policy, trade instruments could be used exclusively for trade policy.

3. Preparation for the FTAA, which promises to be an overarching hemispheric agreement that should absorb the simple free-trade arrangements and coexist with those agreements that have more extensive or deeper commitments. As mentioned, integrating with the large open markets to the north should have many tangible long-term benefits for Latin America, but there will be important costs, and these must be managed in a socially efficient way if commitments are to be sustained and full benefits realized. The Bank has been providing its member countries with technical support during the FTAA deliberations, both through its working groups and individually, and is always on call to consider adjustment assistance when needed.

4. Ensuring compliance with Uruguay Round disciplines. The Bank is supporting training courses and related activities in the region regarding compliance with the WTO disciplines and is exploring setting up a program to allow countries to evaluate their own progress in complying with Uruguay Round disciplines. One hopes that the industrialized countries are monitoring their own progress on this front.

5. Preparing for scheduled multilateral negotiations at the end of the century on key areas such as agriculture, services and intellectual property, and participating actively in the WTO's built-in trade agenda. While the Uruguay Round still remains to be digested, the region should also begin strategic thinking about the possibilities of initiating new multilateral talks early next century, which could multilateralize many of the deeper commitments emerging in regional integration. I believe that most Latin American countries would eventually support such an initiative: Developing countries have the most to gain from multilaterally agreed rules of behavior and market access in the world trading system.

6. Attempting to ensure consistent, fair and transparent multilateral monitoring of integration arrangements under Article XXIV and Article V of the GATT. However, the article and its implementation, even with the important clarifications of the understanding attached in the Uruguay Round, still suffers from a degree of imprecision. The doubts that sometimes are raised about regional integration could be more constructively dealt with in the context of effective Article XXIV reviews with multilaterally agreed criteria and strong empirical foundations. We will follow with interest developments in the WTO's Committee on Regional Agreements, which is examining the relationship between regional trading arrangements and the multilateral system.

7. Last but not least, developing better data collection. Both the advocates and critics of regional integration are prisoners of the serious shortcoming of our theory and models regarding the phenomenon of integration and the poor state of data availability for testing and delimiting the assumptions in those models. Our models have yet to adequately capture the full dynamics of the integration process which, as I mentioned, involve very complicated medium- to long-term general equilibrium issues. Data-availability is troublesome; for example, systematic information on
intra-regional investment flows and firm specialization in the region—central to integration—is highly deficient, as are data on evolution of preferences, application of rules of origin and non-tariff measures, as well as data on other disciplines. Several programs in the Bank that target this problem, including technical support to the FTAA, are beginning to improve data-availability, but the bulk of the work remains to be done. Until we are more successful in overcoming empirical problems for evaluating regional integration, the waters of debate will remain very muddied indeed.

Conclusions

As long as regional integration in Latin America and the Caribbean continues to be an integral part of an overall policy framework of structural economic reform and successfully confronts the challenges that I have outlined, there is good reason to believe that processes of integration will be an effective instrument of growth and development. Moreover, since commitments among neighbors can be uniquely deep and extensive as well as driven by forces that are often more than economic, the multilateral system will coexist with them. While Latin America and the Caribbean pursues regional integration, it also has a vested interest in ensuring that regionalism is consistent with a healthy and progressively more liberalized rules-based world trading system; only with such a system will the region capture the full benefits of economic liberalization. Fortunately, there is growing consensus among economists and policymakers about the potentially positive contribution of the new open regional integration to the world trading system. The trend is well captured in a recent study by the WTO Secretariat, which states: "...to a much greater extent than is often acknowledged, regional and multilateral integration initiatives are complements rather than alternatives in the pursuit of more liberal and open trade."5

Not everyone may yet share this optimism. Indeed, constructive critiques can be a useful filter for processes that can potentially go awry. Nevertheless, I would think that oversight of regional integration would benefit if it were done more effectively at the multilateral level where there can be some agreed criteria based on the needs of world trade and development. Further, constructive evaluation of regional integration requires improvement of our empirical observation of the phenomenon and of the techniques for its measurement and interpretation. This World Bank Conference is fortunately a step in this direction and I am pleased to be part of it. Thank you.

Notes

1. In L. J. Garay and A. Estevadeordal (1995). “Protection, Preferential Tariff Elimination and Rules of Origin in the Americas,” Inter-American Development Bank, Department of Integration and Regional Programs, Division of Integration, Trade and Hemispheric Affairs, there is an analysis of the systems that are applied in the hemisphere.

2. Inter-American Development Bank (1996). “Trade Deviation Compared with Trade Creation: The Case of Mercosur,” in Integration and Trade in the Americas, Department of Integration and Regional Programs, Division of Integration, Trade and Hemispheric Affairs and the Unit of Statistics and Quantitative Analysis, Washington, D.C., periodical note, Annex I.


Missing Lessons of East Asia: Openness, Education and the Environment

VINOD THOMAS
YAN WANG

The Group of East Asian Economies grew faster than other developing regions over the past three decades. The region is currently undergoing severe financial difficulties, but the experience of the past has nevertheless put the focus on the ingredients for long-term growth. As in other fast-growing countries, several compelling factors emerge as major contributors: macroeconomic discipline, outward orientation and human capital investment.

Worldwide, a combination of outward orientation and education has interacted positively, raising the returns to education and to all investments. Openness created the demand for high-skilled labor, improved the quality of education and facilitated learning-by-doing, allowing for technological spillover and industrial upgrading. The importance of this virtuous circle of openness and education—the first link explored in this paper—deserves greater attention among the lessons, and has implications for reform programs everywhere.

East Asian economies, and other rapidly growing countries, have also had periods of poor environmental policies. Openness in trade and investment, while conducive to rapid economic growth and poverty reduction, has not automatically led to environmental protection (Table 1). In fact, the combination of outward orientation and environmental neglect has had an especially negative impact, increasing the urgency for environmental policies. This second link assessed in this paper is also an underemphasized lesson from East Asia.

Unilateral actions for trade liberalization have been the basis for exploiting the positive links between education and openness in East Asia. In this respect, there would seem to be little reason for East Asia to change this approach in favor of regional actions on trade. However, to the extent that countries are likely to take joint rather than separate actions on environmental problems for fear of losing competitiveness, there might be a case for complementary regional efforts in implementing environmental policies such as taxes and standards. While it may be politically difficult to forge regional partnerships, several promising bilateral initiatives for environmental protection are already being implemented in both East Asia and Central America.

The Extent of East Asia's Openness

East Asian economies expanded exports at twice the average rate of other developing countries. These economies more than quadrupled the share of exports in GDP over the past 25 years, from 7 percent in 1970 to nearly 35 percent in 1995 (Figure 1). Their share in foreign direct investment (FDI) to developing countries rose from 16 percent in
TABLE I
Trade, Growth, Poverty and the Environment
(percentages)

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<td>1.9</td>
<td>-0.4</td>
<td>...</td>
<td>0.1</td>
</tr>
<tr>
<td>Bolivia</td>
<td>-0.3</td>
<td>-0.7</td>
<td>7.1 (1990)</td>
<td>1.2</td>
</tr>
<tr>
<td>Brazil</td>
<td>6.2</td>
<td>...</td>
<td>28.7 (1989)</td>
<td>0.6</td>
</tr>
<tr>
<td>Chile</td>
<td>7.3</td>
<td>1.8</td>
<td>15.0 (1992)</td>
<td>-0.1</td>
</tr>
<tr>
<td>Mexico</td>
<td>13.0</td>
<td>0.9</td>
<td>14.9 (1992)</td>
<td>1.3</td>
</tr>
<tr>
<td>Peru</td>
<td>2.4</td>
<td>-1.1</td>
<td>49.4 (1994)</td>
<td>0.4</td>
</tr>
<tr>
<td>Uruguay</td>
<td>0.9</td>
<td>0.2</td>
<td>...</td>
<td>-0.6</td>
</tr>
<tr>
<td>Venezuela</td>
<td>1.1</td>
<td>-1.1</td>
<td>11.8 (1991)</td>
<td>1.2</td>
</tr>
<tr>
<td>Average</td>
<td>4.0</td>
<td>-0.1</td>
<td></td>
<td>0.5</td>
</tr>
</tbody>
</table>

Note: ... indicates missing.
a Uses an international poverty line in the World Development Indicators 1997. Individual studies may have different estimates for the same country.

1970 to 55 percent in 1996 (World Bank 1997b). These trade and investment flows were crucial to the transfer of technology and the gains in productivity. These economies are suffering from setbacks in export declines and financial crises. This, nevertheless, does not call into question the true nature of the East Asian miracle, which quintupled living standards during the past generation.

The East Asian economies have not had the most liberal trade regimes in the world. Several economies in East Asia had moderate import protection in the 1960s and 1970s. In the 1980s, East Asia implemented substantial investment reform and moderate trade liberalization. As late as the mid-1980s, the effective protection rate for manufacturing was nearly 30 percent in the Republic of Korea, 50 percent in Thailand, and 70 percent in Indonesia. But a key difference in East Asia was that import protection did not produce the anti-export bias that it did elsewhere (Dollar 1992; Bhalla 1993; Thomas and Wang 1996). Furthermore, by the end of the 1980s, the protection rates were lowered substantially through reforms.

Since the early 1990s, new waves of trade reforms have been strong and have resulted in substantial reduction in tariffs and quantitative restrictions (Table 2). China has launched several rounds of tariff cuts and eliminated many quantitative restrictions, reducing average tariffs from 43 percent in 1992 to 36 percent in 1995 and 23 percent in 1996. Korea reduced its average tariff rate from 32 percent in 1982 to 7.9 percent in 1994. Malaysia’s overall tariffs average about 10 percent on a trade-weighted basis, and the government has cut or eliminated tariffs on hundreds of items each year since 1992. The Philippines reduced its tariff rate from more than 40 percent in 1980 to about 20 percent in 1994. Taiwan, China implemented a series of tariff cuts, increased the import categories exempt from controls from 34 percent to 85 percent, and switched to a negative list of controlled goods (all other goods being
exempt). Thailand launched reforms aimed at liberalizing its import regime, reducing the number of tariff rates, and eliminating most tariffs that were higher than 30 percent (see Appendix 1).

East Asia complemented trade reforms by opening investment. Among the first generation of newly industrialized economies (NIEs), Hong Kong and Singapore welcomed FDI, but until the mid-1980s, Korea and Taiwan

---

### TABLE 2

**Trade Policies of East Asia and Latin America, 1990–93**

<table>
<thead>
<tr>
<th>REGION/COUNTRY</th>
<th>IMPORTS AFFECTED BY NON-TARIFF MEAN DEVIATION OF</th>
<th>NON-TARIFF TARIFF RATES</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>East Asia</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>36.3</td>
<td>28.0</td>
<td>11.3</td>
<td></td>
</tr>
<tr>
<td>Hong Kong</td>
<td>0.0</td>
<td>0.0</td>
<td>0.5</td>
<td></td>
</tr>
<tr>
<td>Indonesia</td>
<td>19.4</td>
<td>16.1</td>
<td>2.7</td>
<td></td>
</tr>
<tr>
<td>Korea, Rep. of</td>
<td>9.0</td>
<td>6.6</td>
<td>...</td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>14.3</td>
<td>14.0</td>
<td>2.1</td>
<td></td>
</tr>
<tr>
<td>Philippines</td>
<td>20.0</td>
<td>11.0</td>
<td>...</td>
<td></td>
</tr>
<tr>
<td>Taiwan (China)</td>
<td>8.9</td>
<td>10.1</td>
<td>35.9</td>
<td></td>
</tr>
<tr>
<td>Thailand</td>
<td>23.1</td>
<td>16.9</td>
<td>5.5</td>
<td></td>
</tr>
<tr>
<td>Vietnam</td>
<td>12.0</td>
<td>15.5</td>
<td>...</td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td>15.9</td>
<td>13.1</td>
<td>9.7</td>
<td></td>
</tr>
<tr>
<td>Latin America</td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Argentina</td>
<td>9.9</td>
<td>6.9</td>
<td>0.2</td>
<td></td>
</tr>
<tr>
<td>Bolivia</td>
<td>9.7</td>
<td>1.2</td>
<td>2.0</td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>11.1</td>
<td>6.3</td>
<td>1.5</td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>11.0</td>
<td>0.7</td>
<td>0.1</td>
<td></td>
</tr>
<tr>
<td>Colombia</td>
<td>13.3</td>
<td>4.9</td>
<td>1.7</td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>12.6</td>
<td>5.4</td>
<td>3.9</td>
<td></td>
</tr>
<tr>
<td>Peru</td>
<td>17.6</td>
<td>4.4</td>
<td>...</td>
<td></td>
</tr>
<tr>
<td>Uruguay</td>
<td>9.3</td>
<td>7.1</td>
<td>...</td>
<td></td>
</tr>
<tr>
<td>Venezuela</td>
<td>13.4</td>
<td>4.8</td>
<td>2.4</td>
<td></td>
</tr>
<tr>
<td>Average</td>
<td>12.0</td>
<td>4.6</td>
<td>1.7</td>
<td></td>
</tr>
</tbody>
</table>

severely restricted foreign investment to encourage domestic entrepreneurs. The second generation of fast-growing economies in Southeast Asia, and China, have been more receptive to FDI, giving foreign investors some preferential treatment (tax and import tariff exemptions). Since the mid-1980s, most East Asian economies have been lowering restrictions on FDI and removing restrictions on capital transfers. Major areas of reforms include regulations on sector allocation, ownership, local employment, local content and export obligation (see Appendix 2, Table 1). Many East Asian economies have also entered into multilateral agreements on investment, such as the 1987 Association of Southeast Asian Nations (ASEAN) Agreement on Investment, and the 1994 Asia-Pacific Economic Cooperation (APEC) Non-Binding Investment Principles.

Reform of investment regimes has brought big gains: Net FDI flows to East Asia soared from $10.2 billion in 1990 to $61.1 billion in 1996 (Figure 2). FDI has financed between 13 and 16 percent of gross domestic investment in Cambodia, China, Laos, Malaysia, and Vietnam. FDI has promoted exports and provided access to international markets. Firms with U.S. investment have a high export propensity, ranging from 30 percent in Korea to more than 80 percent in Malaysia. In China, foreign-funded firms’ share of total exports rose from 6 percent in 1989 to 39 percent in 1995 to 47 percent in 1996 (SSB of China, 1997). FDI brings new technology and managerial skills, which facilitate learning-by-doing and human capital accumulation.

Trade and investment regimes in East Asia, however, are not as liberal as those in many Latin American countries that recently have carried out major trade liberalizations (Table 2). The tariff level in Latin American countries has been lower than 15 percent, and non-tariff barriers are minimal. East Asian countries have more protective measures, and some sectors (services, for example) are closed to foreign entry. Government interventions are substantial in setting trade and investment policies, and regulations are not fully transparent.

Before the recent setback, East Asia had the best performance of any region in terms of export expansion, economic growth and poverty reduction (Table 1). The question is why, and whether trade and investment liberalizations alone are sufficient for sustainable growth. Previous studies have pointed out the importance of open-

---

**FIGURE 2**

**Foreign Direct Investment in East Asia and Latin America**

![Graph showing foreign direct investment trends in East Asia and Latin America](image-url)
ness, broadly defined to include attitudes toward new ideas and technologies. And East Asia opened up earlier than Latin America in the 1970s and 1980s (World Bank 1993a, 1993b). Further, recent policy reforms in East Asia have significantly reduced barriers to trade and investment.

More importantly, openness, combined with human capital accumulation and institutional factors, enables a country to take off on a growth path and stay on the competitive edge. The synergy between openness and knowledge accumulation in East Asia was crucial for its countries' success in an increasingly competitive world market.

**Openness and Education Together Had an Especially Positive Impact**

Combining education with openness has been the key to achieving international competitiveness and poverty reduction in fast-growing countries. Some East Asian economies have invested heavily in formal education, and in training and learning-by-doing. Educational attainment and enrollment rates are higher in East Asia than in countries with similar income levels, with all their well-known benefits. But it is the combination of the focus on education with an openness to the outside world that produced a series of outstanding results, as elaborated on below.

**The Quality of Formal Education Is Key**

Recent evidence shows that the quality of schooling is high in East Asia, whether it is measured by test scores, teacher/pupil ratios, spending per pupil, repeat rates or dropout rates (Table 3). Government spending on primary and secondary students and teachers' salaries is higher in East Asia than in Latin American countries that have higher per capita incomes. Primary and secondary repeat rates are much lower in East Asia than in Latin America. Barro and Lee (1997) studied the effects of family characteristics and school resources on school outcomes (testing scores) and found that a major component of East Asia's academic performance is left unexplained by family and school inputs.

**Distribution of Education Affects Development**

A more equitable distribution of education across population groups is also crucial for economic development. As with land and physical capital, the equal distribution of human capital is important to growth. Human capital, however, is not transferable between individuals—at least not as easily as is physical capital. Using a model reflecting the non-transferability of human capital, Lopez, Thomas and Wang (1997) estimated Gini coefficients for educational attainment for 11 countries and found that educational inequality has a negative and significant impact on economic growth.

Estimated education Gini coefficients for selected East Asian and Latin American countries show a rapidly improving distribution of education in East Asia (Table 4). Korea has experienced the fastest improvement in education distribution, with Gini coefficients declining from 0.54 in 1970 to 0.24 in 1990, a 56 percent drop. China, too, has seen a dramatic improvement in education Gini coefficients, which dropped from 0.52 in 1975 to 0.44 in 1990, a 16 percent decline. Comparators in Latin America showed initial improvement, but deterioration later. India's education Gini coefficients are among the highest in the world (0.74 in 1990), and they have improved only slowly.

| TABLE 3 |
| Trends in Schooling Quality by Region |

<table>
<thead>
<tr>
<th>REGION</th>
<th>YEAR</th>
<th>PRIMARY SPENDING PER PUPIL</th>
<th>SECONDARY SPENDING PER PUPIL</th>
<th>PRIMARY REPEAT RATE</th>
<th>SECONDARY REPEAT RATE</th>
<th>PRIMARY DROPOUT RATE</th>
</tr>
</thead>
<tbody>
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<td>277</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td></td>
<td>1970</td>
<td>176</td>
<td>385</td>
<td>0</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td></td>
<td>1980</td>
<td>352</td>
<td>521</td>
<td>4</td>
<td>7</td>
<td>10</td>
</tr>
<tr>
<td></td>
<td>1990</td>
<td>494</td>
<td>530</td>
<td>4</td>
<td>1</td>
<td>13</td>
</tr>
<tr>
<td>Latin America</td>
<td>1960</td>
<td>174</td>
<td>435</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td></td>
<td>1970</td>
<td>247</td>
<td>580</td>
<td>15</td>
<td>8</td>
<td>46</td>
</tr>
<tr>
<td></td>
<td>1980</td>
<td>308</td>
<td>479</td>
<td>12</td>
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<td></td>
<td>1990</td>
<td>272</td>
<td>458</td>
<td>10</td>
<td>8</td>
<td>36</td>
</tr>
</tbody>
</table>

Note: ... indicates missing values.

TABLE 4
Inequality of Education: Gini Coefficients for East Asia and Latin America

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>India</td>
<td>77.4</td>
<td>75.9</td>
<td>73.1</td>
<td>72.1</td>
<td>74.8</td>
<td>-2.8</td>
<td>0.8</td>
<td>-3.7</td>
<td>-1.3</td>
</tr>
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<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td></td>
<td>52.7</td>
<td>51.3</td>
<td>44.4</td>
<td>51.4</td>
<td>-7.5</td>
<td>-2.8</td>
<td>-13.4</td>
<td></td>
</tr>
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<td>Korea, Rep.</td>
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<td>35.5</td>
<td>30.1</td>
<td>23.5</td>
<td>36.8</td>
<td>-23.9</td>
<td>-13.4</td>
<td>-15.4</td>
<td>-21.9</td>
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<tr>
<td>Malaysia</td>
<td>58.3</td>
<td>49.3</td>
<td>46.5</td>
<td>43.6</td>
<td>50.4</td>
<td>-7.1</td>
<td>-9.0</td>
<td>-5.7</td>
<td>-6.3</td>
</tr>
<tr>
<td>Philippines</td>
<td>45.9</td>
<td>35.3</td>
<td>35.0</td>
<td>34.0</td>
<td>37.5</td>
<td>-18.5</td>
<td>-5.3</td>
<td>1.0</td>
<td>-2.6</td>
</tr>
<tr>
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<td>46.5</td>
<td>46.4</td>
<td>42.6</td>
<td>42.1</td>
<td>45.1</td>
<td>2.4</td>
<td>-2.6</td>
<td>-8.2</td>
<td>-1.3</td>
</tr>
<tr>
<td>Latin America</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>36.2</td>
<td>34.8</td>
<td>34.4</td>
<td>34.3</td>
<td>35.3</td>
<td>1.5</td>
<td>3.2</td>
<td>-1.1</td>
<td>-0.3</td>
</tr>
<tr>
<td>Colombia</td>
<td>55.9</td>
<td>50.5</td>
<td>50.6</td>
<td>51.4</td>
<td>51.3</td>
<td>-11.7</td>
<td>2.4</td>
<td>0.1</td>
<td>1.6</td>
</tr>
<tr>
<td>Mexico</td>
<td>55.3</td>
<td>52.0</td>
<td>49.0</td>
<td>49.0</td>
<td>51.8</td>
<td>3.4</td>
<td>2.6</td>
<td>5.8</td>
<td>0.0</td>
</tr>
<tr>
<td>Venezuela</td>
<td>65.3</td>
<td>41.9</td>
<td>42.0</td>
<td>45.5</td>
<td>51.0</td>
<td>-7.5</td>
<td>-30.5</td>
<td>0.2</td>
<td>8.2</td>
</tr>
</tbody>
</table>

Source: Lopez, Thomas and Wang, 1997. Authors' calculations, based on Barro and Lee's (1997) data on education attainment and school year data from UNESCO.

Why has investment in education been more equitable, and with high quality, in East Asia? According to Barro and Lee (1997), it may have reflected an "Asian value" broadly defined as the cultural and religious beliefs that emphasize education. But why is this effect not found in South Asian countries? An alternative explanation is that the external environment—openness in trade and investment—has generated higher returns to education and thus has given students, employees and employers strong incentives to invest in learning.

**Openness Provides Higher Returns to Education**

Investing in basic education does not by itself guarantee growth. Openness in trade and investment can provide higher earning opportunities and raise returns to education. A World Bank study (1995) compared earnings in highly protected economies with those in export-oriented economies and found that protected economies have lagged in manufacturing earnings and in employment growth. Real earnings per worker grew in Korea, Malaysia and Thailand from 2 to 8 percent annually from 1970 to 1990, while they declined in closed economies. Export-oriented economies have seen wage employment growth far exceeding the population growth, and faster growth of earnings for skilled workers. Thus, returns to education are much higher in terms of both job opportunities and higher earnings. In Malaysia, wage employment tripled between 1957 and 1989, while the share of the labor force working in agriculture fell from 58 percent to 26 percent. In Chile and Mexico, the wave of trade liberalization has coincided with increased wage and income inequality. In Mexico's maquiladora enterprises, the ratio of non-production (white-collar) to production wages rose from 2 to 2.5 between 1985 and 1988. In Chile between 1980 and 1990 the wages of university graduates rose by 56 percent relative to those of high-school graduates (World Bank 1995, pp. 33 and 56).

**Openness Facilitates Learning-by-Doing**

Rapid integration into the global market has allowed the importation of knowledge-enhancing capital, and facilitated learning-by-doing, technological catch-up and industrial upgrading. Openness to international competition combined with government intervention has enabled these countries to create comparative advantages and maintain competitiveness in the world market. Recent studies have produced evidence showing the importance of FDI in generating technology spillover through training and transfer of technology. The following cases illustrate the linkage between openness and learning-by-doing.

Companies in many fast-growing countries have actively used international technology transfers as an investment in learning. They have been large importers of modern technology through FDI, subcontracting and licensing. The training components of technology-transfer agreements with foreign companies frequently cover not
only the acquisition of the skills needed to operate and maintain new facilities (the know-how), but also the skills and capacities for designing, engineering and managing projects (the know-why) that can be used to generate innovation and technological change. In 1993 the share of machinery imports of total imports (a proxy measure for embodied technology) was 42 percent in China and Indonesia, 54 percent in Malaysia, 45 percent in Thailand, and 32 to 34 percent in Korea and the Philippines. Similarly, this share was even higher in Latin America: 43 percent in Chile and 50 percent in Argentina. But this number was 14 percent in more closed economies such as India and Bangladesh (World Bank 1997a).

The Case of Malaysia’s Electronics Industry. Malaysia is the world’s leading exporter of semiconductors and the third largest producer of semiconductors after Japan and the United States. In 1987, electronics exports were Malaysia’s top revenue earner, contributing $6.9 billion to the national account. FDI and technology and skills transfers from multinationals made this achievement possible. The Investment Incentives Act of 1968, the establishment of free-trade zones in 1972, and specific incentives for the electronics industry attracted the influx of foreign companies. Foreign investment transformed the industry from a labor-intensive operation in the early 1970s to a capital- and technology-intensive operation today.

Rapid technological change and significant skills transfer and capacity building characterize the electronics industry in Malaysia. Continuing investments by multinationals have resulted in the establishment of local research and development capability and a gradual expansion of production into areas of higher technology. Many multinationals have set up formal apprenticeship programs, scholarships, and skills development courses. An example of the successful transfer of skills and technology is the Penang Skills Development Center, a public/private joint venture. The Center offers training courses to the entire manufacturing sector and has emerged as one of the country’s leading training institutes (World Bank 1994).

The Case of China. In China, export expansion and FDI have promoted knowledge spillover and productivity growth. Using data from 434 urban areas, Wei (1993, 1996) found that export expansion from 1980 to 1990 was positively associated with higher growth rates. In the late 1980s, however, FDI became the main engine of growth. Its contribution came from technological or managerial spillover across firms, as opposed to an infusion of new capital. Finally, the dazzling growth of the coastal regions can be explained entirely by their effective use of foreign capital and their export orientation. Husain and Wang (1996) find that per capita FDI is positively and significantly associated with variations in GDP per capita growth among Chinese provinces. Also, the output share of foreign-funded firms is positively related to economic and productivity growth.

The Case of Chile and Costa Rica. The exports of these two countries have displayed high growth rates and diversification both in terms of their products and destination markets. Both have combined “implicit” export-promotion policies with imaginative selective and institutional promotion policies. In Chile, a system of returning a percentage of the FOB value of exports is especially beneficial for small and medium exporters. In addition to trade liberalization and fiscal incentives, export promotion has included an institution-building component. Public and private institutions have played a fundamental role in export promotion through programs to identify markets and to provide technical assistance in the production, sales, and marketing of goods (Inter-American Development Bank 1996, p. 100).

These cases show, to some extent, that fast-growing countries are able to combine openness and learning, forming a virtuous circle: Openness creates demand for learning, and learning and institution-building make a country’s export sector more competitive. The cases also show that learning and knowledge accumulation involve a localized process. In other words, one firm or one country can learn to learn, or to become more efficient in managing knowledge accumulation in the course of production and trade (Stiglitz 1987).

The Two-Way Link: Education and Openness
Recent economic literature generally supports the above observations and suggests two-way links between education and openness. First, knowledge accumulation influences a country’s trade performance and competitiveness (Grossman and Helpman 1989, 1990; Romer 1990); and second, trade enhances knowledge-accumulation, especially through imports (Ben-David and Loewy 1995; Coe and Helpman 1993; Keller 1995; and Padoan 1996). Lucas (1993) pointed out that to sustain any kind of knowledge accumulation, a country would have to be outward ori-
ented and a significant exporter. Young (1991) and Keller (1994) noted that trade per se cannot be the engine of growth; rather, it must be through some mechanism, such as the formation of human capital, that it affects growth. The impact of trade openness on long-term growth, therefore, depends on the absorptive capacity of local human capital.

Beyond the case studies from East Asia and elsewhere, there is broader evidence of the education/openness link. For example, an earlier study found that in a sample of 60 developing countries from 1965 to 1987, economic growth rates were especially high when there was a combination of a high level of education and macroeconomic stability and openness (World Bank 1991, p. 5). More narrowly, Thomas and Wang (1997) looked at the possible interaction of openness and education and its impact on the performance of the World Bank’s lending projects. On average, countries with a more educated labor force and a more open economy have a 3 percentage points higher rate of return than those that had only one or the other (Figure 3).

The detailed findings of this study suggest that increases in education and openness might have interacted to promote the returns to investment. First, we find a positive and significant relation between changes in the level of education and lending project performance, whether measured by the probability of receiving a satisfactory rating or by economic rate of return. Second, in the regressions, the variable for the interaction between education and openness also has a positive and significant association with project performance. The findings are consistent with the observations in the case studies and suggest that openness facilitates the importation of knowledge-enhancing capital, promotes learning-by-doing, and provides higher payoffs to education.

**FIGURE 3**

*Education and Openness Interact and Increase Investment Returns*

Note: Economic rates of return are from the evaluation database of the Operations Evaluation Department. Education is measured by the average level of schooling of the labor force, and openness is measured by the logarithm of the foreign exchange parallel market premium.

Source: Authors' calculations.
Openness and Environmental Neglect Had an Especially Negative Impact

East Asia's environmental record stands in contrast to its phenomenal economic growth and poverty reduction. In the past quarter century, income grew at an average rate of 5 percent a year. The incidence of poverty fell sharply, declining by an estimated 50 to 70 percent in Indonesia, Malaysia and Thailand (Johansen 1993). At the same time, environmental losses and degradation in East Asia have surpassed those of any other region in the world.

Nine of the world's 15 cities with the highest levels of air pollution are located in East Asia. About 20 percent of all vegetated land suffers soil degradation from waterlogging, erosion and overgrazing. About 50 to 75 percent of coastlines and protected marine areas are classified as having highly threatened biodiversity (World Resources Institute 1996). The region has some of the highest deforestation rates in the world. The countries that implemented trade reforms in the 1980s, such as China, Malaysia and Thailand, have seen some measures of pollution double or triple after reforms. From 1980 to 1992, carbon dioxide emissions rose from 1,489 million tons to 2,668 million tons in China, from 28 million tons to 70 million tons in Malaysia, and from 40 million tons to 112 million tons in Thailand (Table 1).

Is Growth Primarily to Blame?

Openness in trade and investment, though conducive to rapid growth and poverty reduction, is not an automatic ally of the environment. Rapid growth has come at the expense of the environment and has generated attendant social costs, such as the negative effects of air and water pollution on human health. Rapid growth does not automatically improve the environment—environmental policies must be put in place simultaneously. Many growth-inducing policies, such as clarifying property rights, investing in sanitation, improving education and ensuring sound macroeconomy, help to improve resource use and contribute to a better environment. But in crucial areas government actions, such as imposing taxes and standards, investing in technology and improving production methods, are necessary. Rapidly growing economies are learning this lesson the hard way, and some are now taking corrective actions.

It is interesting to compare Southeast Asia (Indonesia, Malaysia, Singapore and Thailand) and Central America. Southeast Asia has grown rapidly and achieved a sharp reduction in poverty. Environmental losses have been serious—pollution, congestion, deforestation and loss of biodiversity. The Central American economies have grown slowly for a variety of economic and sociopolitical reasons. An exception is Costa Rica, a country with a strong record of promoting human development. But more generally, the economies of Central America have been dominated by traditional exports, which have faced declining terms of trade; by highly unequal income distributions; and by inadequate educational investment, exacerbated by political instability. Because growth has been slow, poverty levels have remained stubbornly high. Environmental quality has deteriorated, too, as evidenced by extensive deforestation, soil degradation, overfishing and water pollution in coastal zones.

Thus, both slow- and fast-growing economies can suffer from severe environmental degradation. Within East Asia, there was not much difference in water and air pollution levels and congestion in Manila, where growth was slow in the 1980s, and the rapidly growing Bangkok area. Likewise, natural resource indicators, such as freshwater withdrawal per capita, appear to be comparable in East Asia and Latin America (World Bank 1997a).

Growth per se, therefore, cannot be blamed for environmental degradation. When the sources of environmental problems—underpriced resources (be it forests, water or air), weak institutions, unclear property rights and the neglect of externalities—are not adequately addressed, rapid growth seems to worsen the problem. However, growth and high incomes can be harnessed to mitigate environmental degradation and improve resource use if accompanied by timely environmental actions.

Most rapidly growing countries have taken the approach of growing first and cleaning up later. Evidence shows that this is a costly strategy socially and ecologically, and could threaten the sustainability of growth itself. The damages are much costlier to address later, if not irreversible in some instances. Furthermore, new approaches and technologies are now becoming available that make it worthwhile socially to address growth and environmental sustainability together rather than in sequence.

Many Asian and Latin American economies are beginning to take corrective actions. In East Asia, subsidies on gasoline, diesel and kerosene fuel are being removed. Latin America has begun to use market-based instruments. The Philippines has developed a unique system of national parks and protected areas. Brazil, Colombia and Venezuela
charge a forestry tax for tree-harvesting undertaken without equivalent reforestation. Public participation and community involvement can be effective, especially where institutions are weak and enforcement is expensive. For example, in Japan the local governments and resident groups negotiate with firms to arrive at a detailed written agreement on emission levels. Between 1971 and 1991, the number of agreements increased from approximately 2,000 to 37,000. Once standards were agreed on, they were effectively implemented.

**Are Environmental Standards a Rationale for Regionalism?**

Such unilateral actions by individual countries may not be sufficient, however. No country is isolated in the global environment. One country’s actions in resource use and pollution can affect the welfare of its neighbors. Thus, a first argument for taking regional environmental actions is based on externalities. Because of the negative spillover effects of one country’s environmental neglect, regional actions might be necessary.

The second argument is incentive-based. If one country unilaterally implements environmental standards, it might fear losing its competitiveness. A common agreement for all countries in a region to act on the environment might reduce this concern. Thus, there is an incentive for countries to participate in collective action and to implement environmental standards in the context of a regional agreement. The commitment by all countries in a region would motivate each individual country to take action.

The degree of optimal action by each country varies, since the benefits and costs of environmental controls vary across countries. Regional agreements, therefore, might ideally be differentiated across countries on the economic grounds of benefits and costs. But on political and administrative grounds, the standards might have to be uniform across countries. To balance these two opposing factors, regional agreements might be uniform for a threshold (minimum) degree of environmental controls, with higher standards on top of the minimum standards implemented by individual countries in the region.

Third, global agreements on the environment might be difficult to achieve. They might take years to negotiate, as did the Uruguay Round, which took eight years. Regional agreements on tougher environmental standards might expedite this process, forming building blocks for multilateral agreements (for discussions see Appendix 2; Bhagwati and Panagariya 1996; Srinivasan 1996; Winters 1996). If some regional agreements can successfully address environmental concerns, it would be easier to achieve a global agreement on environmental standards.

East Asia, it would seem, has little reason to pursue regionalism, especially discriminatory regionalism, in the areas of trade and investment. East Asia did not pursue regionalism during the first wave in the 1950s. Reasons for such lack of regionalism include: first, historically, the major players in the region used to be political rivals; second, these countries had very different levels of protection, and large adjustment costs can arise for less developed and more protective economies if a free-trade area is formed; third, since the size of most economies was still small, trade relations were traditionally oriented toward distant markets, particularly North America, Europe, and Japan (see Appendix 2).

In a rapidly integrating global economy, there would seem to be a generally declining need for regionalism. East Asian economies have experienced rapid integration, with their trade accounting for more than one-third of all developing country trade. And these economies remain committed to the principle of multilateralism and to keeping their regional arrangements nondiscriminatory. This determination was reconfirmed by commitments undertaken at the APEC meetings in Tokyo and Subic Bay.

There might be a rationale for regional efforts to implement environmental protection in view of the above arguments. To the extent that countries are likely to take joint rather than separate actions on environmental problems for fear of losing competitiveness, there are strong incentives for regional action. Concerted regional action on environmental policies and standards might be encouraged, which may well be the building blocks for multilateral agreements. The most efficient means to combat environmental problems are direct policies such as environmental standards or taxes. East Asia, in view of its economic success, can create a model for achieving environmental protection by using instruments such as taxes and standards, while maintaining open trade regimes.

**Bilateral Initiatives for Environmental Protection**

Regional and multilateral actions on environmental standards are promising, but reaching consensus on this scale is not likely to be easy. Thus, there is a need to develop bilat-
eral initiatives in parallel. Both East Asia and Central America have taken the lead in this regard. An agreement between NEES (a power company in the United States) and the Innoprise Corporation in Sabah, Malaysia, aims to promote reduced impact of logging in tropical forests. The incremental costs associated with this environmentally friendly logging technique are borne largely by NEES. But both partners stand to benefit—Malaysia through the preservation of its soils, water and biodiversity, and NEES by accumulating carbon offset credits.

In Central America, Costa Rica has been most active in achieving forest protection by developing a market mechanism of payments for environmental externalities. The pilot phase of Activities Implemented Jointly (AIJ), a recent agreement with Norway, helps to protect large tracts of natural forests in Costa Rica. The country benefits via the conservation of its forests, while Norway (and the world community at large) gains through carbon sequestration and mitigation of the threat of global warming (see Kishor and Constantino 1994). These agreements demonstrate the power of international trade in environmental services to benefit both the developing and developed countries. In addition, bilateral partnerships for environmental protection need not be restricted to forestry—they have been successful in the areas of energy generation and conservation, and controlling air and water pollution, as well. However, it must be noted that the success of such international partnerships depends on economic and political stability, and an outward-looking development policy in the host countries. Clearly, once these preconditions are satisfied, bilateral schemes hold strong potential for environmental protection in developing countries.

Conclusion

Investing in education was a key to rapid development in many parts of the world. Openness and competition created the demand for high-skilled labor, raising the returns on education and learning. In addition, effective learning improved the competitiveness of export industries. The link between openness and the accumulation of human capital raised returns on all investment. This was the basis for the rapid growth and poverty reduction in East Asia. The financial crisis in East Asia does not call into question the true nature of East Asian development, which quintupled living standards during the past few decades.

But openness in trade and investment and rapid economic growth did not automatically lead to environmental protection. Experience showed the need for complementary actions to protect the environment. The implication is not to stop liberalizing trade and investment regimes, but rather to implement strong environmental policies along with liberalization.

The international experience shows that trade and investment liberalization produces especially strong results when coupled with learning and capacity building in the course of the reforms. No group action by economies was needed in these respects, however. On the other hand, to the extent that countries are likely to take joint rather than separate actions on environmental problems for fear of losing competitiveness, there might be a case for regional action to directly address environmental protection through environmental policies.

References


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World Bank (1996). Managing Capital Flows in East Asia. East Asia and
Notes

1. Calculation of Gini coefficients for education takes two steps. First, Lorenz curves are drawn, which are similar to that of income, with percentage of population aged 15+ on the horizontal axis, and percentage of cumulative education on the vertical axis. Gini for education is then calculated by the ratio of the area between the diagonal and the Lorenz curve divided by the total area of the half-square in which the curve lies.

2. Borenstein, de Gregorio and Lee (1995) find that, beyond a minimum threshold, higher FDI inflows are associated with higher productivity of human capital, indicating that FDI may have positive spillover effects through the training of workers. Other studies have found that FDI in developing countries is associated with the transfer of technology (see, for example, Blomstrom, Lipsey and Zejan 1992).

3. Updated to 1994 later.

4. The cross-country, project-level data set includes variables on education, per capita income, openness, government expenditure and project performance. The project data cover 3,590 lending projects in 109 countries evaluated by the Operations Evaluation Department (OED) between 1974 and 1994, with the OED rating of overall performance (satisfactory/not) and economic rates of return.

5. Grossman and Krueger (1994) found that economic growth brings an initial phase of environmental deterioration that is followed by a subsequent phase of improvement. The turning point usually comes when a country reaches a per capita income of $8,000. Using a revised model, Gale and Mendez (1998) found that increased economic activity has a negative effect on the environment, while changes in per capita income have a positive, and linear, relationship with the environment. The trade policy measure is not significant, and its effect is ambiguous a priori. And pollution rises with the capital abundance of a country (since this favors capital-intensive and dirtier industries) and falls with increases in labor and land abundance.

6. Using a computable general equilibrium model, it was shown earlier that East Asian countries would benefit the most if they take concerted unilateral trade liberalization on a most-favored-nation (MFN) basis (World Bank 1994).
Appendix 1

A Review of the Recent Reforms in Trade and Investment Regimes

Reforms in Trade

China has launched bold trade reforms, including several rounds of tariff cuts and elimination of quantitative restrictions. In 1992, the government announced sizable reductions in tariff levels on 225 tariff lines, and the abolition of import regulatory duty. In 1994, the foreign-exchange retention system and mandatory import plan were abolished, and import licensing requirements and quota controls on 320 items were eliminated. In 1995, import restrictions on 367 tariff lines were abolished. The average tariffs were reduced from 43 percent in 1992 to 36 percent in 1995, and again to 23 percent at the beginning of 1996.

In the Republic of Korea, a five-year tariff reduction plan ended in 1994, when the average Korean tariff rate was reduced from 32 percent in 1982 to 7.9 percent. As part of the Uruguay Round settlement, the government will continue to reduce tariffs and to eliminate most of its import restrictions by 1997.

Malaysia's overall tariffs average about 10 percent on a trade-weighted basis, and import licenses are required for a small range of products, such as tobacco and plastic resins. The government lowered or eliminated tariffs on over 600 items in the 1993 budget, and on more than 500 items in the 1994 budget. In the 1995 budget, import tariffs on another 2,600 items were reduced, largely to meet its commitments in the Uruguay Round and the ASEAN Free Trade Area (AFTA).

The Philippines reduced its tariff from more than 40 percent in 1980 to about 20 percent in 1994. The Ramos Administration has expanded reforms by liberalizing trade, foreign exchange, and investment regimes; reducing entry barriers in vital industries (most recently in banking, telecommunications and insurance); and encouraging private sector investments in much-needed infrastructure. The country has embarked on a path of sustained strong growth.

Taiwan, China has implemented a series of tariff cuts. In the course of GATT negotiations, Taiwan has committed to liberalize its trading regimes in many sectors, such as manufactured products and agricultural products and services. In July 1994, it simplified import procedures for its 8,500 import categories by implementing a negative list. This list increases the percentage of import categories exempt from controls from 34 percent to 85 percent.

Thailand has launched a flurry of legislative and regulatory reforms aimed at liberalizing the domestic market. A wider reform of the import regime reduced the number of tariff rates and eliminated most tariffs above 30 percent. In 1993, Thailand began implementing the AFTA tariff reductions, which will gradually eliminate the exclusion list of protected items and generally expand AFTA into a real free-trade area.

Reforms in Investment Regimes

China: Special economic zones were established in the early 1980s and preferential treatments were given to foreign-funded enterprises. In 1988, the government adopted a new Chinese-foreign cooperative joint ventures law. In 1990, an amendment to the 1988 law was adopted which simplified the approval procedures for new foreign investment enterprises. In January 1994, the official exchange rate and the swap market rate were united. Profit repatriation is subject to some restrictions, and foreign-exchange balancing is required.

Indonesia: By enacting a new deregulation package in June 1994, Indonesia took a big step forward in improving its investment environment. The package, known as PP20, eliminated initial foreign equity requirements and significantly lowered divestiture requirements. Both solely foreign-owned projects and joint ventures with a minimum domestic equity of 5 percent are now provided for by Indonesian law. Several previously restricted sectors are opened to foreign investment, including telecommunications, electricity generation, airlines and railways.

Korea: Changes in regulations announced in June 1994 resulted in a streamlining of foreign investment application procedures and easing of a number of barriers to direct foreign investment. At the same time, the opening up of several sectors that had previously been closed to foreign investors was accelerated. Changes in laws and regulations also make it easier for foreign companies to purchase land for business purposes.

Malaysia: Malaysia began deregulating slowly in the late 1960s. The Investment Incentives Act of 1968 and the establishment of free-trade zones in 1972 encouraged an influx of foreign companies. In the 1980s, freer capital movements were allowed and large FDI flows led to the
TRADE: TOWARDS OPEN REGIONALISM

expansion of a number of export-oriented industries. In 1992, the guidelines on foreign equity capital ownership were liberalized. Foreign investors are permitted to hold equity of up to 100 percent if they export 80 percent or more of their production. For projects exporting less than 80 percent, the share of foreign equity ownership depends on such factors as the level of technology, spin-off effects, size of the investment, location, value added, and the use of local raw materials and components. Projects producing high-technology products or priority products for the domestic market, as determined by the Malaysian government from time to time, may be allowed foreign equity ownership of up to 100 percent.

The Philippines: The Foreign Investment Act of 1991 allows full foreign ownership of companies engaged in activities not covered by investment incentives. (There was a 40 percent ceiling imposed by previous investment regulations.) In addition, the "negative list" of sectors, where foreign ownership is either banned or limited, was greatly reduced. In 1994, the government liberalized the entry and scope of operations of foreign banks in the Philippines.

Singapore: To attract foreign investment, many of its public policy measures are tailored to ensure an environment conducive to their efficient business operations and profitability. While seeking to develop more high-tech industries, the government does not impose restrictions on production standards, requirements of local purchases, or percentage of output exported. Since 1989, the telecommunication sector has been steadily liberalized. In 1990, the maximum limit on the proportion of foreign shareholding in the local banks was raised to 40 percent from 20 percent.

Taiwan: Remaining investment barriers have been reduced both as part of its WTO accession process and as part of its drive to become a regional operations center. Local content requirements have been phased out for most manufacturing industries. In addition, Taiwan has removed many discriminatory limits on foreign securities firms, insurance companies and banks.

Thailand: In May 1990, the government announced a series of measures to significantly liberalize the exchange control regime. The central bank also raised limits on capital transfers abroad and allowed free repatriation of investment funds, dividends, profits and loan repayments.

Vietnam: A new law on foreign investment was approved in December 1987, providing for three forms of foreign investment including categories of full foreign ownership. In 1992, an amendment to the 1987 law was approved. Under the amendment, further liberalization measures included the extension of the duration of joint ventures to 50 years from 20 years (and, exceptionally, to 70 years), and that domestic private firms were allowed to participate with foreign firms in investment projects.

Sources: U.S. Department of State 1997, and IMF various years.
Appendix 2

Background on Regionalism vs. Multilateralism in East Asia

**Literature review**

Regionalism refers to discriminatory trade liberalization by a group of countries. The definition of multilateralism, however, varies. Winters (1996) proposes that a country’s multilateralism index is a positive function of (a) the absence of discrimination in its trade policy; and (b) the closeness of its trade regime to free trade. The basic static welfare of discriminatory trade liberalization can be explained by the concepts of trade creation and trade diversion, introduced by Jacob Viner (1950). A free-trade area (FTA) is likely to be beneficial if, on balance, it gives rise to more trade creation than trade diversion. Ceteris paribus, the higher the initial tariff, the lower the difference between the prices of the two supplies of imports; and the larger the economic size of the union, the more likely the free-trade area will improve efficiency—that is, there will be more trade-creation than trade-distortion generated.

Bhagwati and Panagariya (1996) focus on the dynamic time-path issue and ask the question whether regional arrangements are “building blocks” or “stumbling blocks” to multilateral free trade. “Regionalism vs. Multilateralism” switches the focus of research from the immediate consequences of regionalism on the welfare of the participating countries to the question of whether regionalism will lead to worldwide free trade more quickly or more slowly. Economists are very divided on this issue.

Frankel and Wei (1995) carefully review the arguments about whether regional arrangements will be building blocks or stumbling blocks to multilateral free trade. Regional FTAs could be building blocks to global free trade by the following arguments: (a) If groups are organized into customs unions, the multilateral negotiations will be made more efficient; (b) It may be easier for the political leadership in a country to get support for liberalization within a regional context than in a multilateral or unilateral context; (c) The threat of regional integration may facilitate the liberalization among groupings; and (d) Progressive expansion of regional groupings may eventually lead to multilateral free trade.

Regional agreements could be stumbling blocks to global trade integration by the following arguments: (a) A free-trade area may end up being an instrument of protection rather than liberalization; (b) There are incentives for trading blocs to raise rather than lower tariffs on outside countries; and (c) When the choice of regionalism is offered in the battle against protectionists, the political process may take the regional route to the exclusion of multilateral free trade.

Winters (1996) first classifies the theoretical contributions on the issue into five broad groups. These models suggest that the relationship between regionalism and multilateralism can go either way. He then evaluates the actual experience, which is very limited. The tentative conclusions he draws include that regionalism may: (a) help to liberalize highly restrictive trade regimes; (b) increase the vulnerability of less restrictive regimes to break down; and (c) be more likely to be a danger if governments are subject to sector-specific lobbying forces. Winters (1997) examines the effects of regional integration on excluded countries’ welfare and surveys various ex ante estimates of the impact of European integration. These estimates suggest that neighboring countries linked tightly to the European economy could lose significantly from the latter’s integration, but that for other countries the losses are likely to be very small.

**A Brief Review of the History of Regionalism in East Asia**

The Early Years. After the Second World War, East Asia did not court regionalism, while the first wave of regionalism, launched with the founding of the European Community (EC) in 1957, swept large parts of Western Europe, Africa and Latin America. There was only one regional arrangement founded during this period: the Association of South-East Asia Nations (ASEAN). Even this arrangement did not create significant trade preferences among its member nations. There were six members of ASEAN: Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand. Excluding Singapore, which is a free-trading country, intra-ASEAN trade accounted for less than 5 percent of the countries’ trade. Of this, less than 5 percent was subject to any kind of trade preferences.

There are three reasons for such lack of regionalism in East Asia. First, historically, the major players in the region have been political rivals. Second, these countries have very different levels of protection and are at very different stages
of development. Hence, large adjustment costs can arise to less developed and more protective economies if a free-trade area is formed. Third, since the size of most economies is still small, trade relations have traditionally been oriented toward distant markets, particularly North America, Europe and Japan.

New Wave of Regionalism. The second wave of regionalism started in 1989, three years after the Tokyo Round, when the United States was unsuccessful in persuading the EC and developing countries to undergo another round of multilateral trade negotiations (MTNs). Believing that an ever-expanding set of free-trade areas (FTAs) could achieve worldwide free trade, U.S. Ambassador William Brock turned to regionalism as an alternative instrument for sustaining the movement for free trade. The switch in tactics proved a turning point in the history of regionalism and launched what Jagdish Bhagwati called the Second Regionalism. Pursuit of regionalism in North America and Europe has led a dramatic pursuit of regional pacts around the world. Between 1989 and 1994, there were 33 regional agreements. With regard to Asia, in 1990 the East Asian Economic Caucus (EAEC) was formed. In 1992, members of ASEAN signed an agreement to form the ASEAN Free-Trade Area (AFTA) by 2007. In 1995, south Asian countries announced plans to form a South Asian Preferential Trading Area (SAPTA).

The Future of Liberalization in East Asia. Until now, the impact of regionalism on East Asia from its own regional arrangements has been minimal. How should Asia respond to the growing regionalism around the world? Today, the issue of regionalism has resurfaced in East Asia. This development has manifested itself in the recent signing of the ASEAN Free-Trade Area (AFTA). At the September 1994 meeting in Chiang Mai, AFTA members agreed to reduce the 15-year implementation schedule to 10 years, gradually to eliminate the exclusion list of protected items, and generally to expand AFTA from a tariff-reduction scheme into a real free-trade area.

However, regional trading integration among developing countries with high external trade barriers has been tried since the 1950s. It has served primarily to extend the national import substitution policies to the regional level, and failed to deliver faster growth. So far, both qualitative and quantitative analyses lead to the conclusion that regional trade arrangements such as AFTA and SAPTA are not particularly desirable. Gains from such arrangements, if there are any, will come from their contribution to the speeding up of nondiscriminatory liberalization in the participating countries.

The World Bank (1994) considered several options for further liberalization in East Asia. Unilateral reform and preferential blocs were found to benefit the country or group of countries engaging in liberalization, but they offered small benefits or possible losses to trading partners. Concerted most-favored-nation (MFN) trade liberalization by East Asian countries was found to offer greater welfare gains to the region, and to major trading partners. The report argued that East Asia is well positioned to take a leading role in concerted multilateral, non-preferential trade and investment liberalization, which is a win-win solution to world trade tensions. Leaders of the Asia Pacific Economic Cooperation Forum (APEC) have been moving in this direction—a concerted multilateral liberalization.
**APPENDIX 2 TABLE 1**

**Trade and Investment Policies in East Asia (1996)**

<table>
<thead>
<tr>
<th>Member of Multilateral/Regional Trade Organization</th>
<th>Exchange Control</th>
<th>FDI Policies</th>
<th>Export Promotion Policy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cambodia</td>
<td>Two exchange rates; license required for engaging in foreign exchange transactions</td>
<td>Eliminated the foreign exchange restrictions applying to investors in Cambodia; profits repatriation is permitted in accordance with relevant laws and regulations</td>
<td>N/A</td>
</tr>
<tr>
<td>China</td>
<td>One exchange rate determined in the inter-bank market</td>
<td>Full ownership allowed under restricted conditions; local content required on a case-by-case basis; restriction apply to transfer of profits and foreign exchange balancing is required</td>
<td>Some incentives and special benefits</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>Fixed exchange rate; no exchange controls</td>
<td>Few restrictions; no restrictions on transfer of profits</td>
<td>No direct government support</td>
</tr>
<tr>
<td>Indonesia</td>
<td>Managed float; no foreign exchange control since 1972</td>
<td>Full ownership permitted in certain sectors if the investments meet certain criteria; barriers in service sectors; divestment is eventually required for foreign ownership; no restrictions on transfer of profits</td>
<td>Preferential treatment on import duties</td>
</tr>
<tr>
<td>Korea, Rep. of</td>
<td>Market average rate system; no direct foreign exchange controls</td>
<td>Set-up of local partnership is no longer required; no restrictions on transfer of profits</td>
<td>Tax privileges have been continuously reduced</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Market determined flexible rate; some foreign exchange controls</td>
<td>Full ownership allowed if export 80% or more of their production; most service sector protected; no restrictions on transfer of profits</td>
<td>Export allowance and tax incentives to exporters</td>
</tr>
<tr>
<td>Philippines</td>
<td>Market-determined flexible rate; most foreign exchange restrictions were liberalized since 1992</td>
<td>Full ownership allowed for companies engaged in activities not covered by investment incentives, but “negative list” of sectors remains; no restrictions of transfer of profits</td>
<td>Various incentives granted to investment in export industries</td>
</tr>
<tr>
<td>Singapore</td>
<td>Managed float; no formal exchange controls</td>
<td>No restrictions on FDI, except some restrictions in the service sector; no restrictions on transfer of profits</td>
<td>No exports subsidy, although the government actively promotes it</td>
</tr>
<tr>
<td>Taiwan, China</td>
<td>Market-determined floating exchange rate; some foreign exchange controls</td>
<td>Some restrictions on FDI; significant incentives to attract FDI in export-oriented industries; no restrictions on transfer of profits</td>
<td>Generally no export subsidy or tax incentive to exporters, but exceptions do exist</td>
</tr>
<tr>
<td>Thailand</td>
<td>Managed float; in 1990, a series measures to liberalize the exchange controls</td>
<td>Few restrictions on FDI, certain sectors are closed; no restrictions on transfer of profits</td>
<td>Various incentives and special benefits</td>
</tr>
<tr>
<td>Vietnam</td>
<td>Exchange transactions permitted for six currencies and trading must take place within the official range</td>
<td>No maximum limit on foreign capital share, but a minimum of 30% share is required. No sectors are closed. Some de facto restriction of profit repatriation</td>
<td>N/A</td>
</tr>
</tbody>
</table>

APPENDIX 2 TABLE 2
Evolution of Foreign Direct Investment and Trade Performance in East Asia and the Pacific vs. Latin America and the Caribbean

<table>
<thead>
<tr>
<th>YEAR</th>
<th>FDI IN EAP (NET IN US$ MILLIONS)</th>
<th>EXPORTS AS A PERCENT OF GNP IN EAP</th>
<th>FDI IN LAC (NET IN US$ MILLIONS)</th>
<th>EXPORTS AS A PERCENT OF GNP IN LAC</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970</td>
<td>201</td>
<td>7.59</td>
<td>1,091</td>
<td>12.40</td>
</tr>
<tr>
<td>1980</td>
<td>1,312</td>
<td>21.19</td>
<td>6,148</td>
<td>17.84</td>
</tr>
<tr>
<td>1989</td>
<td>8,350</td>
<td>24.99</td>
<td>8,138</td>
<td>18.28</td>
</tr>
<tr>
<td>1990</td>
<td>10,179</td>
<td>27.28</td>
<td>8,121</td>
<td>18.18</td>
</tr>
<tr>
<td>1991</td>
<td>12,706</td>
<td>28.66</td>
<td>12,504</td>
<td>17.44</td>
</tr>
<tr>
<td>1992</td>
<td>20,923</td>
<td>30.23</td>
<td>12,740</td>
<td>16.83</td>
</tr>
<tr>
<td>1993</td>
<td>38,128</td>
<td>31.48</td>
<td>14,066</td>
<td>16.22</td>
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<tr>
<td>1994</td>
<td>44,105</td>
<td>33.00</td>
<td>24,238</td>
<td>16.52</td>
</tr>
<tr>
<td>1995</td>
<td>51,776</td>
<td>33.51</td>
<td>22,897</td>
<td>19.32</td>
</tr>
<tr>
<td>1996 Preliminary</td>
<td>61,120</td>
<td>31.17</td>
<td>25,925</td>
<td>20.39</td>
</tr>
</tbody>
</table>

II. Assessment of Regional Integration
Assessing Regional Integration

L. ALAN WINTERS

IT IS FLATTERING TO BE ASKED TO PRESENT AN OVERVIEW PAPER AS THE SPEAKER FOR THIS HIGH-
QUALITY PANEL, BUT IT IS NOT EASY. THE CONFERENCE ORGANIZERS HAVE COMMISSIONED A SERIES OF EXCELLENT
PAPERS AND COLLECTED A SET OF EXCELLENT PARTICIPANTS TO EXPLORE THE PAST AND FUTURE SUCCESS OF REGIONAL
INTEGRATION IN THIS REGION. THE LAST THING WE NEED AT THIS STAGE IS SOMEONE SKIMMING RAPIDLY OVER THE
WHOLE FIELD PURPORTING TO OFFER DEFINITIVE ANSWERS TO THE QUESTIONS WE ARE ABOUT TO TACKLE. Thus this
PAPER IS NOT AN ASSESSMENT OF REGIONAL INTEGRATION WITHIN LATIN AMERICA AND THE CARIBBEAN, BUT RATHER
A DISCUSSION OF HOW WE MIGHT GO ABOUT MAKING SUCH AN ASSESSMENT. I HOPE THAT IT WILL HELP TO DEFINE AN AGENDA
AND SOME RULES OF DEBATE FOR THE CONFERENCE RATHER THAN THE OUTCOME OF THE CONFERENCE. I ALSO, OF COURSE, HOPE
THAT IT WILL HELP TO DEFINE THE FUTURE RESEARCH AGENDA FOR THIS IMPORTANT, BUT COMPLEX, TOPIC.

FIRST, SOME TERMINOLOGY: ECONOMISTS AND POLICYMAKERS HAVE INCREASINGLY COME TO RECOGNIZE THE ECONOMIC BENEFITS
OF INTEGRATION BETWEEN THE ECONOMIES OF DIFFERENT NATIONS—E.G., SACHS AND WARNER (1995), WORLD BANK
(1996). THUS THE ISSUE IS NOT WHETHER REGIONAL INTEGRATION PER SE IS DESIRABLE, BUT WHETHER REGIONAL INTEGRATION
EXPLICITLY PURSUED AND FOSTERED BY DISCRIMINATORY POLICY INTERVENTIONS IS DESIRABLE. FOR THIS REASON I SHALL TALK OF
REGIONAL INTEGRATION ARRANGEMENTS (RIAS) AND TRY TO DO SO IN STUDIALLY NEUTRAL TERMS. AS MARTIN WOLF HAS NOTED, TER-
MINOLOGY CAN AFFECT THE WAY WE THINK ABOUT SOMETHING:

Names matter. Who but a staunch protectionist could have anything against a “free trade agree-
ment”? “Preferential trade agreements” sound less benign, while “discriminatory trade agreements,” yet
another name for the same thing, sound nasty…."

—Financial Times,

I SHOULD ALSO NOTE THAT WHILE MOST RIAS ARE REGIONAL IN
THE GEOGRAPHIC SENSE, THIS IS NOT NECESSARY FOR MOST ANALYT-
ICAL DISCUSSION. Thus, I shall use the term RIA for any recipro-
cal preferential or discriminatory arrangement between two or more countries.

This paper is restricted to the “direct effects” of RIAs—
those that follow immediately and causally from the initi-
ation of the RIA rather than those that occur indirectly
because the RIA induces other changes in economic policy.
Thus, I consider so-called static effects, through which
RIAs affect trade patterns, the changes in economic welfare
emanating from such effects, and dynamic effects on eco-

L. Alan Winters is Research Manager in the International Economics Department of the International Trade Division of the World Bank. I
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ism” elsewhere (Winters 1996a). It also, however, reflects the suspicion that for individual governments and policymakers, the direct effects, especially those on their own countries, are likely to be the more important: That is, only rarely will systemic considerations reverse decisions made on the basis of direct effects.\(^1\)

It is useful to set out the agenda and some debating rules for at least two reasons. First, discussions of RIAs are always complex and frequently diffuse. There need to be at least three countries, and everything occurs in a world that is “second-best” in the technical sense that distortions and policy interventions are present in every outcome we consider—specifically, restrictions on trade with non-member countries.\(^2\) As a consequence, there are few general and unambiguous economic results to appeal to: each case is sui generis. Additionally, many of the alleged costs and benefits of RIAs are in areas that economists understand relatively poorly even without regional complications—for example, growth, technology transfer, political economy and political benefits. Moreover, there are few cases of significant regional integration on which to base empirical studies (Foroutan 1997), which increases the burden borne by our already inadequate theory.

A second reason for suggesting some rules of debate is that RIAs seem to arouse more passion than do most other issues of international economic policy. Thus, for many years, to attack the Common Agricultural Policy (CAP) was to be held to be attacking the European Community itself. Even in the 1990s, academic worries about whether the European Union (EU) had the best of all possible trade policies and growth records (Winters 1993) were greeted by comments that the analysis showed the state of the author’s “mind rather than his heart about EC [European Community] integration” (Sapir 1993, p. 230). Passion of this kind is not helpful analytically, and I offer my guidelines as a possible means of preventing its onset.

An interesting question is why RIAs stir up such emotion. After all, individual countries’ agricultural policies have been criticized as roundly as has the CAP, and individual countries’ trade policies as roundly as has Mercosur’s, without such outbursts. I suspect two basic causes. First, no criticism is more wounding than one that identifies a failing that one has recognized oneself but decided to live with; since regional blocs’ policies are compromises negotiated between partners, one partner is always in this position. Moreover, defending the compromise in the name of the bloc can easily become the touchstone of loyalty for members regardless of their view of the substantive issue.\(^3\)

Second, regional blocs generally have fewer policies and sources of identity than do individual countries, and thus adverse comment on one of them is more threatening to the blocs’ existence than it is for a country. To attack Swiss agricultural policy does not undermine the concept of a Swiss state, but, particularly in the early years, to advocate abolition of the CAP was to attack one of the few concrete manifestations of European unity and thus to threaten the European dream. In Winters (1996a) I explore more fully the dangers of identifying integration with progress on particular policies.

As blocs mature, and as they acquire broader and deeper sources of identity, it should be possible to discuss individual policies more calmly. Analytical discussions should seek to reach this stage from the outset by being explicit that it is not the existence of regional arrangement ‘x’ that is under discussion, but the policies it pursues. That discriminatory trade policies might be harmful does not undermine the desirability of cooperating with and integrating naturally with neighboring countries.

**Standards of Comparison**

We all know the joke about the economist who, when asked, “How is your wife?” replied, “Relative to what?” He worked on RIAs. Perhaps the most difficult part of assessing the effects of an RIA is to work out what would have happened in its absence—the anti-monde, or counterfactual. In fact, for ex post studies using the residual imputation method, this is the only question. These studies take actual data on some phenomenon after an RIA has been created and attribute the difference between them and an anti-monde to the RIA. Anti-mondes vary from the simple (and frequently implicit) “no change from pre-RIA values” to complex model-based predictions based on exogenous data.

For ex ante studies of the sort that must be used for discussions of policy options, the anti-monde has to be constructed, but again “no change” is the most frequent choice. Thus, for example, modelers such as Haaland and Norman (1992) or Harrison, Rutherford and Tarr (1997) calibrate their models to actual data for a historical (base) year and then shock it with changes to represent the RIA they are investigating. Thus, their estimates are as if “1992” happened in 1985, and the anti-monde is the base-year actual values.
If economies are developing very rapidly, "no change" is not adequate, and it is necessary to be more explicit about the anti-monde. This inevitably involves judgment. Thus, for example, if we are assessing the effects of introducing free trade within Mercosur over the period 1991–95, what do we assume about internal tariffs in the absence of Mercosur? We could assume that Mercosur has made no difference to the evolution of tariffs, so that if it had not come about, intra-Mercosur trade would have paid the same as extra-Mercosur trade (anti-monde = 1995 actuals on non-members); alternatively, we could assume that all tariff changes would have stopped in 1991 (anti-monde = 1991 actuals), or that some most-favored-nation (MFN) liberalization would have continued (anti-monde based on trends of liberalization over, say, 1988–91). It makes a huge difference.

Once we move beyond simple tariffs, anti-mondes become even more complex. If we believe that RIAs foster the credibility of policy reforms, how do we represent credibility in their absence?

My conclusion from this is that we should always be explicit about the anti-monde and be prepared to justify our choice (if only within our own heads).

A second issue of standards of comparison concerns the indicator we examine. An economics profession of the current size can be justified only in terms of making life better—that is, in terms of someone's welfare. We might still debate whose welfare—we, i.e., what welfare weights to use (including those of future generations)—and whether and how to incorporate supposedly non-economic dimensions of welfare, such as security, culture, etc. We should also be clear whether results refer to the welfare (suitably aggregated) of the citizens of one or all of the member countries in the RIA, those of non-members, or those of the world as a whole. But in the end, I believe that we must come back to welfare. In practice, however, many discussions of RIAs are conducted in terms of intermediate variables such as aggregate output (GNP) or levels of trade. This is legitimate, for we must simplify to make problems manageable, but it requires care. The mere observation that international trade has increased—still less that intra-RIA trade has increased—is not sufficient to declare that an RIA is desirable; think of the CAP again. Thus we should always bear in mind the links between the variable under examination and welfare.

A particular way in which intermediate stages of analysis can confuse us is the use of the term "natural trading partners." If this term has any role in the assessment of RIAs, it requires (a) that we can, as a general proposition, equate "natural" with "desirable," and (b) that, for the RIA in question, we cannot make a direct assessment of its desirability, for otherwise we could jump straight to the latter without worrying about "naturalness." As a practical matter of discourse we also need (c) to be able to define and measure "naturalness."

In fact, neither requirement (a) nor (c) is very secure. Some commentators define "natural" in terms of outcomes (volumes of trade between potential partners)—Summers (1991)—while others focus on transportation (or transactions) costs—Krugman (1991). In the former case, large flows are far from sufficient to render preferential liberalization beneficial (Panagariya 1997; Schiff 1996), while in the latter, relative transportation costs may not matter (Amjadi and Winters 1997) or may have perverse effects (Nitsch 1996a). Overall, therefore, I believe that we would be better off not using the term "natural trading partners" or "natural integration," except in the sense I used in the Introduction as meaning without any policy inducements.

The rest of the paper considers some of the arguments that have been advanced for and against creating RIAs. It obviously cannot do them justice in a single paper, but I hope to give a feeling for the nature of the arguments, identify their critical components—particularly in the dimensions just noted—and comment briefly on empirical or practical aspects of their application. I start with the simple static effects of regional integration which, despite a huge and venerable literature, still appear to generate some confusion.

**Static Analysis**

**A Priori Analysis**

The traditional tools for RIA analysis—Viner's (1950) trade creation and trade diversion—are marvelous heuristic devices for illustrating the fundamental effects of RIAs. If, as a result of a preferential-tariff reduction, imports from a partner displace higher-cost local production, real resources are saved in satisfying local consumption, and the domestic economy benefits accordingly. This is trade creation. If, alternatively, the preferences allow partner supplies to displace those from non-members that would otherwise have been purchased because they were cheaper when both faced equal tariffs, the domestic economy ends
up paying more real resources for imports and loses accordingly. This is trade diversion, and it amounts to diverting part of what would have been tariff revenue on imports from non-members to producers in the partner country who now face no tariffs.

Unfortunately, except in the very simple case explored by Viner, the mapping from trade creation and diversion to economic welfare is treacherous. For example, pure trade diversion can be beneficial if its effect of lowering consumer prices is sufficiently important to welfare. The benefits of trade creation for a single country can be outweighed by the losses of tariff revenue on the pre-RIA volume of imports from the partner country, i.e., by returning to partner producers the tariffs on those imports purchased from them even in the absence of preferences (Panagariya 1997). Thus, ultimately, simple creation and diversion exercises are indicative rather than definitive. Nonetheless, because they are so pervasive and intuitively appealing, it is worth thinking briefly about their empirical basis. Before doing so, however, I consider two other aspects of static behavior.

One of the early puzzles about why countries adopted RIAs was that in neoclassical analysis they could always do better by an MFN liberalization. Wonnacott and Wonnacott (1981, 1992) offered a solution by observing that, if trade with the rest of the world was costly because of their tariffs or transactions costs, two partners might be able to make terms-of-trade gains by removing tariffs on their mutual trade and trading only with each other. This requires that trade with the rest of the world cease; otherwise, internal prices would remain anchored to world prices plus the tariff. Overall, such changes in trade patterns do not seem very realistic. Amjadi and Winters (1997) explore the possibilities of these sorts of gains in Mercosur. Transport costs with the rest of the world are high enough for there to be substantial savings by switching to intra-bloc trade, but the requirement that trade with the rest of the world completely cease seems unlikely to be fulfilled in any but a few commodities.

Transportation costs also matter in the models based on differentiated goods, such as Frankel, Stein and Wei (1994) and Nitsch (1996b). As in Wonnacott and Wonnacott, this is because they rely on corner solutions, in which there is no trade with the rest of the world; this means that even marginal changes in trade result in changes in internal prices. In models of this kind, each good from each supplier is unique and hence faces a downward-sloping demand curve; thus, all changes in tariffs or other trade barriers are partially passed through to consumers, resulting in changes in consumer welfare and, through changes in consumption bundles, pressures on other (domestic and non-preferred) suppliers to adjust their prices and quantities. This gives much more scope for RIAs to have real welfare effects than do homogeneous good models in which world prices, assumed fixed, tend to anchor domestic prices. A problem with many differential goods models, however, is that through their assumptions of symmetry (all goods compete equally with all others), they ignore comparative advantage and/or "home preference," and hence overemphasize trade diversion—see Srinivasan (1993) and Jones (1993). Symmetry also means in these models that results depend on relative intra- and extra-bloc transport costs rather than absolute transport costs. Amjadi and Winters (1997) suggest that for the Mercosur countries and Chile this relativity is sufficiently small that only minor benefits from RIAs are likely.

Once products are differentiated we open the way to consider models of RIAs under imperfect competition. Starting from Smith and Venables (1988), much literature has emerged in which RIAs are generally predicted to have much larger effects than perfectly competitive models suggest. Market integration changes the nature of competition—almost always reducing market power by enlarging the scope of each market and removing some domestic players' special privileges. This generates additional gains to the usual allocative ones. The existence of rents in imperfect competition, which get shifted about by trade changes, also make RIAs more strongly redistributive, usually with larger benefits to small previously oligopolized economies. Several authors in Winters (1992) report important advances in this genre, and Baldwin and Venables (1996) give a more recent survey.

The imperfect competition literature has given RIAs a new lease of intellectual life (as it has international trade theory in general), but it should not be accepted completely uncritically. For example, the permanence of oligopolistic positions is not guaranteed even without RIAs, especially in the face of a determined government. If RIAs dominate MFN liberalization—as is possible in these models—it is at the expense of the rest of the world. It is not guaranteed that intra-bloc competition really will be fiercer—see Haaland and Wooton (1992) in theory and
Jacquemin and Sapir (1991) in practice. The latter found that French, German, Italian and United Kingdom profit margins were significantly squeezed by extra-EC imports but not by intra-EC imports. It is not clear that the EU has really shifted from being 15 segmented markets to a single unified one as is assumed in most analyses, and it is certainly not clear that Mercosur or the Andean Pact would. Finally, we have, to date, no empirical tests of these models at all.

**Estimating Static Effects Ex Post**

The simplest approach to *ex post* estimates of creation and diversion is to look at the evolution of partner and non-partner shares of total imports. The typical *anti-monde* is that, absent the RIA, these shares would not change. But even putting aside the potential weaknesses of the anti-monde, this approach cannot separate trade creation from trade diversion. Writing $M_N$ for imports from non-members and $M_p$ for imports from partners, one is examining $M_p/(M_p + M_N)$. Clearly this can increase if $M_N$ rises in isolation (creation) or if $M_p$ rises as $M_N$ falls by the same amount (diversion).

To identify creation and diversion, one clearly requires an extra piece of information. One approach, emanating from Truman (1969), is to add sales of domestic output ($D$) to the equation and look at shares in apparent consumption. Thus if $S_p = M_p/(M_p + M_N + D)$ we have creation, whereas if it rises at the expense of $S_N$ we have diversion. For applications of this approach on Europe see, for example, Winters (1993) and Sapir (1992). At an aggregate level these shares are often approximated by corresponding shares in GDP (relying on the fact that $M_p + M_N = X$, where $X$ is total exports).

A novel alternative approach to identifying trade diversion is due to Yeats (1997). He recognizes that intra-bloc imports, $M_p$, equal intra-bloc exports, $X_p$, and uses $X_N$ to suggest an anti-monde for $X_p$. Yeats illustrates his method on Mercosur, and focuses on the compositions of $X_p$ and $X_N$. He finds that the strongest increases in $X_p$ occur in products for which performance in $X_N$ is very weak. Since members’ exports are competing with the same third-country exports in $P$ and in $N$, Yeats infers that the much greater relative success for some of them in $P$ is due to preferences. That is, $X_p = M_p$ displace $M_N$ in Mercosur because of preferences—i.e., there is trade diversion. Note that the anti-monde here is based on world markets and thus is closer to non-discriminatory trade than to the members’ pre-Mercosur situations.

A problem with anti-mondes based just on changes in import (or export) shares is that they fail to take account of changes in the relative sizes of economies as they grow at different rates. For example, the huge growth of the East Asian economies in the last three decades would lead us to expect that, ceteris paribus, their shares in partners’ trade would grow strongly. One solution is to look at trade intensity ratios—the share of $i$ in $j$’s imports relative to the share of $i$ in the world’s imports. The level of this index is obviously influenced by factors such as geographical proximity and $i$’s and $j$’s comparative advantages as well as by trade policies, but changes in the index will primarily reflect changes in the last because the other factors are so static. Anderson and Norheim (1993) show how dramatically these indices changed during European integration, and Yeats (1997) shows dramatic changes for Mercosur countries after 1991. Changes in trade intensity indices do not identify actual trade diversion due to Mercosur—the increased intra-bloc trade could all be at the expense of domestic sales—but if Mercosur and non-Mercosur goods do actually compete, and if shares in world markets reflect general competitiveness, then changes in intensity indices do reflect trade diversion relative to a situation of non-discriminatory liberalization.

The third way to establish an anti-monde for an RIA is by reference to the trade patterns of other countries. The *locus classicus* for this is Aitken’s (1973) use of the gravity model on the EEC, but see also Braga, Safadi and Yeats (1994) on Latin America. In Aitken’s model it is again impossible to separate trade diversion from trade creation (that, ceteris paribus, imports from partners exceed those from non-partners is consistent with either), but later scholars have done so by defining “normal” trade independent of the RIA members’ behavior and then checking whether $M_p$ is significantly higher than the norm (creation) and/or $M_N$ significantly lower (diversion). Recently, Bayoumi and Eichengreen (1996), Frankel and Wei (1996) and Sapir (1997) use this sort of approach to suggest that the creation or enlargement of the EC did, in fact, cause material amounts of trade diversion, a significant change in the conventional wisdom.

**A Diversion on the Rest of the World**

The discussion so far has focused on the effects of RIAs on their members, but equally important is their effects on
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non-members. Even the simple comparative static issue of how an RIA affects non-member trade and welfare has caused a good deal of confusion. The traditional approach has been to consider the evolution of the share of non-members in each member's imports—i.e., $M_N/(M_N+M_P)$—or apparent consumption—i.e., $M_N/(M_N+M_P+D)$. This is not an implausible approach to the trade effects. The anti-monde is that, ceteris paribus, shares would have been constant, which is probably reasonably accurate over the short run. As the time period of investigation increases, however, it becomes less relevant, as factors such as different partners' ability to supply imports and the different income elasticities of demand for different imports become more significant. In these circumstances—just as for members' own trade shares—a more sophisticated view of anti-monde shares is required, such as provided by trade intensity indices, trade propensity indices, more complex import functions or a gravity model.

While the shares of different suppliers in members' total imports offer some insight into the effect of RIAs on members' welfare as well as on their trade, they offer virtually none into non-member welfare (Winters 1997a, b). First, even if non-member exports to the RIA were the correct driver of non-member welfare, it is the absolute level, not its ratio to total RIA imports, that affects the evolution of welfare through time. The ratio is informative only relative to the gains that non-members would have made if the same expansion of members' imports, had been made in a non-discriminatory fashion—that is, not relative to the initial situation but relative to an MFN liberalization.

Second, and much more important, the level of their exports is a poor indicator of non-members' welfare. At the extreme, if ceteris are strictly paribus, more exports implies fewer goods for non-member consumption, i.e., it correlates with lower welfare! Of course, exports are actually a means to obtaining imports, which do raise welfare, but then we should consider the effects of the RIA on non-members' imports and/or their terms of trade. To my knowledge these have never been investigated, although in Winters (1985) I noted that British exports of manufactures to certain non-EEC markets fell below expected levels following British accession to the EEC. But even this is not particularly informative if British exports were replaced by other supplies of equivalent quality and price.

The observation that a non-member's trade with members of an RIA might easily be substituted by trade with other countries is essentially a comment on the economic size of the RIA. If the RIA is small in the technical sense of having no perceptible influence on the prices at which other countries trade, non-members should be indifferent to its creation. Although if the RIA cuts its exports to the rest of the world (RoW), the shortfall must fall somewhere (not every member of RoW can replace the lost imports), the loss is so marginal that it is effectively zero. Thus, a critical question about the effect of an RIA on non-members must be its effect on prices, or the terms of trade. Again, to my knowledge, no exercises of this sort have been published, although recent work by Gupta and Schiff (1997) and Winters and Chang (1997) is starting to address this lacuna. The former argue that unusual tastes or barriers to trade with RoW can make even a small RIA large to certain neighbors, and it illustrates the possibilities with beef trade between Argentina, Peru and Venezuela, with the formation of the Andean Pact, and with white maize trade when the Central American Common Market broke down. The latter authors examine the relative prices of EC and non-EC exports of machinery to Spain over the Spanish accession in 1986; it finds evidence consistent with non-EC suppliers receiving lower prices. Further work on the price effects of RIAs seems a high priority, although as Winters and Chang observe, it is not easy to do.

Deep Integration and Security of Access

The standard discussion of RIAs proceeds as if tariffs were the only barrier to trade, and as if once these had been set to zero within the bloc, that was the end of the story. Of course, this is far too simple. First, there are myriad other costs to international trade other than tariffs—for example, currency exchange and its associated uncertainty, customs formalities, industrial standards, and unfamiliar legal structures. Unfortunately, we know very little about these even for industrial countries, but experience suggests they are real enough. Herin (1986) estimates that such costs average 3 percent of the gross value of a trade flow, and most analyses of the EC's "1992" program assume that they are 2½ percent (see, for example, Smith and Venables 1988 or Winters 1992). McCallum (1995) shows that trade between Canada and the United States, among the most integrated of partners, is subject to additional costs equivalent to adding an extra 2,000 miles to an equivalent intra-U.S. trade.
Reducing transaction costs should be an important objective of policy, because they not only segment markets and reduce competition, but typically waste real resources in doing so. In many cases, however, this seems feasible only in a discriminatory—i.e., geographically limited—way. As long as different currencies and standards exist within the world economy, for example, harmonizing with one partner automatically precludes harmonization with another. Thus, this sort of "deep integration" seems ideally suited to RIAs. "Discriminatory" deep integration can have trade-creation and trade-diversion effects just as can discriminatory tariff reductions, but with one crucial difference: If trade barriers entail the expenditure of real resources rather than the creation of rents, reducing them saves the real resources and is thus, at least in simple models, welfare-improving even if it diverts trade. It is just that you get lower gains if there is diversion than if the reduction is non-discriminatory. Overall, therefore, discriminatory deep integration seems unlikely to be harmful except in the sense of forgoing the greater gains from non-discriminatory integration.\(^9\)

If deep integration is so benign, why do we not see more of it? The reason is that it is formidably difficult and sensitive to achieve. It requires great mutual trust and confidence between partners as well as a perception that their interests in various issues are compatible. For example, achieving a single currency entails surrendering a fundamental element of sovereignty, and forgoing a major tool of (short-run) economic management. Harmonizing standards can entail agreeing about the trade-offs between, say, costs of production and safety, and always appears to favor the partner whose standard is adopted by the group. Experience in the EU amply illustrates the difficulties and slow pace of deep integration, although it may be easier to achieve among developing countries with less long-lived traditions of this sort of economic management and more fluid institutions.

In assessing RIAs ex post deep integration is not conceptually difficult except when one tries to separate the integration that would occur "naturally" and via global forces (e.g., through network economies or via the World Trade Organization) from that which is induced by the RIA. In ex-ante assessments, however, one needs to exercise the self-discipline of asking exactly how and in what areas deep integration will be achieved—who will surrender what and how. If deep integration is necessary for an RIA to be beneficial, it is clearly desirable to answer such questions before embarking upon it.

One final question warrants some thought: Are trade preferences necessary to the achievement of deep integration? In some cases, clearly not: Countries already share some standards (e.g., electrical power, and compatible railway gauges and timetables) but nonetheless impose tariffs on each other's goods. In other cases, probably not: Even if countries use the same currency, they could tax mutual trade. In yet other cases, preferences are necessary: It is hard to abolish frontier formalities if you wish to levy taxes on cross-border trade.

Deep integration concerns facilitating market access, but in the real world the security or reliability of access is nearly as important—for both exporters and importers. RIAs enhance security by making it more difficult to increase tariffs on partner trade. Even a bound tariff can be raised under GATT rules so long as the increase is negotiated and compensation is offered, and an RIA may offer more direct routes for retaliation than does the GATT. But, in fact, raising bound tariffs is relatively rare under the GATT because governments can achieve similar results without renegotiation via safeguards actions and without either renegotiation or compensation via anti-dumping actions. How do RIAs affect these instruments?

Within the EU (as between U.S. states) allegations of dumping would be investigated under the auspices of competition policy. This imposes more rigorous standards of proof than does anti-dumping law—so rigorous that misconduct is rarely claimed or identified—and also is administered by a super-national body, eliminating the strong "them vs. us" rhetoric of dumping. Under these circumstances, RIAs more or less assure market access, although on occasion pragmatic restrictions on access have emerged within the EU—e.g., on cars made by Japanese firms in EU countries. Also, EU members exercise anti-dumping against third countries collectively through EU organs as is required by a common trade policy. I believe that Mercosur intends to move to the EU situation, but it has not yet created the necessary institutional framework.

Among less deep RIAs, to my knowledge only three have eschewed anti-dumping: Australia-New Zealand, Canada-Chile, and Iceland-EU. In NAFTA and in the EU's agreements with Eastern European and Mediterranean countries, the northern partners have maintained the right to institute anti-dumping actions against their partners. In
both cases the institutional arrangements have been changed somewhat, but not in ways that seem to have obvious effects on the frequency or rigor of the use of the instrument. In the EU cases, the parties have to refer cases of alleged dumping to association councils—relatively high-level joint political bodies—to seek a “solution acceptable to the two parties.” This approach arguably encourages managed trade outcomes to complaints of dumping, but possibly gives the developing country partner more power in negotiation. While the EU’s use of anti-dumping against Eastern European countries seems to have declined since the RIAs were signed, it is still the subject of bitter complaint among the latter.

NAFTA, building on Canada-U.S. Free Trade Agreement (CUSFTA), has established a new review process for anti-dumping actions, based on bilateral panels. However, the panels’ terms of reference are linked to procedural rather than substantive issues. NAFTA is too recent for its effects on anti-dumping to be isolated, but Bond (1997b) has studied the effect of CUSFTA on U.S. actions against Canadian exporters and finds no statistically significant changes.

Security of market access figured prominently in the aims of the developing partners to NAFTA and the Europe Agreements; the issue of anti-dumping was negotiated vigorously in both cases. In neither case did the developing partners gain much on paper, but one might plausibly assume that their treatment has become a little gentler de facto—certainly it is not likely to have become worse. On the other hand, the one formal test extant has failed to identify such benefits. For prospective members of RIAs the brutal truth is that the major industrial users of anti-dumping are unlikely to give up much of their discretion, and thus that one should not expect too much in this direction even from far-reaching RIAs. For RIAs among developing countries, which are newer converts to the delights of anti-dumping, it may be feasible to reach mutual disarmament agreements, but it is probably necessary that these be formally part of the agreement before much reliance can be placed on them.

Finally, some commentators have hoped that RIAs will also earn their members more sympathetic treatment under sanitary and phytosanitary—for example, Chilean views on joining NAFTA (see Schiff and Sapelli 1996). Except in so far as an RIA opens new routes to disputes-settlement or facilitates closer cooperation in standards and testing, the evidence we have to date is not encouraging to this view.

Dynamics

Dynamics play an almost mystical role in many discussions of economic integration. Having found that the static benefits are usually rather small or possibly even negative, advocates of regional integration arrangements (RIAs) typically appeal to the dynamic benefits. However, what these constitute and how they come about are frequently rather vague, and the evidence linking dynamic benefits to particular instances of integration very difficult to pin down.

This section defines dynamics as anything that affects a country’s rate of economic growth over the medium term. Thus, it includes both permanent increments to the rate of growth and temporary but long-lived increases of, say, more than five years, as countries move from one growth path to another. It then briefly introduces some of the arguments made about dynamics and seeks to isolate their critical components. As with the previous section, the aim is to try to put discussion of dynamic costs and benefits on a more objective basis—to force us to be explicit about what we expect of RIAs.

Improvements in growth stem from accumulation either of a factor of production—specifically capital, physical or human—or of knowledge. Traditional growth theory suggests that accumulating factors will eventually run out of steam, for as one adds ever more units of physical and human capital to a fixed stock of land and laborers, their rates of return decline to such an extent that further accumulation appears unprofitable. Some recent endogenous growth theorists have sought to avoid these constraints by arguing that production exhibits constant returns to scale in capital and increasing returns to scale overall. On the whole, however, this is difficult to believe, and recent work by Jones (1995) has offered a refutation in the case of the United States. The accumulation of knowledge, on the other hand, could lead to permanent increases in rates of growth, for as an economy grows, the return to an increment in knowledge (which is basically a public good) increases, and as knowledge accumulates, the base for further advances expands.

The direct evidence that RIAs stimulate growth is actually rather weak. Henrikson, Torstensson and Torstensson (1997) use a cross-section regression to suggest that European integration has enhanced members’ growth rates, but other commentators—e.g., deMelo, Panagariya and Rodrik (1993) and Vamvakidis (1997)—have failed to do so with similar approaches. Part of the difference lies in the
treatment of openness. Vamvakidis identifies an EU growth effect if he excludes openness from his equation, but he finds it insignificant if openness is included. He does find beneficial effects on a country's growth rate from large open neighbors, but this is quite independent of RIAs. To date no one has identified any growth effects from non-European RIAs (see the brief discussion in Baldwin and Venables 1996).

Attractive as the sweeping generalizations from cross-section regressions are, they are not wholly persuasive. They offer no information on the mechanisms through which growth occurs, and may well be subject to simultaneity problems. Thus the rest of this section looks at alternative, less direct arguments and evidence.

Whether we are talking about permanent changes in the rate of growth or only temporary ones, we must remember the distinction between output and welfare. Accumulation is not free, so while an RIA might raise the growth rate of output, total economic welfare will not increase by as much, because the investment in plant, education or knowledge has to be paid for in terms of forgone consumption. Not every increase in the rate of growth—still less in investment—is welfare-improving.

**Convergence and Spillovers**

Convergence is the phenomenon by which countries' incomes per head converge toward each other over time. Over the last 10 years a huge amount of effort has been devoted to describing and explaining convergence. The classic references include Baumol, Blackman and Wolff (1989); Lucas (1988); Mankiw, Romer and Weil (1992); and Barro and Sala-i-Martin (1995). The evidence suggests rather strongly that the world's economies do not converge unconditionally, but many economists maintain that economies do converge conditionally, such that, after allowing for a series of other explanatory variables, the remaining unexplained component of growth shows poorer economies growing more rapidly than richer ones, and thus converging. The explanatory variables are used either to explain the steady-state levels of income per head toward which each country is converging, or to explain differences in growth rate for a given level of steady-state income. Among the variables that are used for these purposes are human capital, the rate of investment, political stability and the openness of the economy. (For a recent survey see de la Fuente 1995.)

Since this paper is concerned with economic integration, I shall concentrate on the work of just one economist—Ben-David (1993, 1994, 1995, and 1996). Ben-David (1993) offers very striking evidence that after they signed RIAs, the EEC, the European Free Trade Association and the United States and Canada displayed a marked increase in trade between members and a dramatic fall in the standard deviation of incomes per head across countries. Ben-David (1994) suggests that this convergence is upward—i.e., it increases the growth rates of poorer members.

Ben-David (1995) extends the analysis to explore the role of trade in creating so-called convergence clubs, small groups of countries (not necessarily linked by RIAs) that appear to display convergence. He finds that if we create clubs between countries that are each other's major trading partners, convergence is a very common phenomenon, whereas if we create similarly sized clubs by drawing countries randomly, convergence is very rare. This appears to reinforce the view that international trade is the mechanism through which convergence occurs, although it might equally well be other elements of international commerce, such as foreign direct investment (FDI), that are strongly correlated with trade.

Finally, Ben-David (1996) uses the same set of countries as the previous article to demonstrate that the convergence clubs appear to owe more to convergence in rates of total factor productivity growth than to convergence in rates of investment. This suggests that convergence arises from contact and spillovers rather than from incentives to accumulate physical capital. It might also be due to the stimulating effect of overseas competition on economic performance, to the direct consequences of technology improvements through FDI, or even to the mobility of highly skilled labor, be it permanently or temporarily.

It would be comforting to infer from all this that a developing country has only to increase its trade with a richer country in order to experience a rapid catch-up. Unfortunately, however, this would be premature. First, while convergence appears between OECD countries, it is not generally evident between them and other countries (Ben-David 1994). Second, Ben-David's recent work includes very few developing countries—all middle-income countries in Latin America. Thus, we do not know how well the experience will translate to developing countries in general. Third, the extent to which preferences lie behind an RIA's or a convergence club's increase in trade
rather than, say, the reduction in real trade costs clearly matters. Overall, however, Ben-David's work does offer some encouragement for expecting dynamic benefits, especially from North-South RIAs.

A separate stream of work that also shows the role of international trade in convergence is Coe, Helpman and Hoffmaister (1997), who seek to explain the rate of increase in total factor productivity across a wide range of countries. They construct an index of total knowledge capital (measured by accumulated investment in R&D) in each industrial country, and then assume that trading partners get access to a country's stock of knowledge in proportion to their imports of machinery and transport equipment from that country. Using import-weighted sums of industrial countries' knowledge stocks to reflect developing countries' access to foreign knowledge, they seek to explain the latter's total factor productivity (TFP) growth. They find that access to foreign knowledge is statistically significant.

In the case of developing countries, Coe, Helpman and Hoffmaister find TFP growth is related to the interaction between the openness of the economy (imports/GDP) and its access to foreign knowledge. Thus an economy benefits from foreign knowledge first according to how open it is, and second according to whether it is open to those countries that have the largest knowledge stocks. These results are intuitively very attractive and suggest, again, that trade is a major conduit for spillovers between countries. Unfortunately, however, the conclusion is not wholly secure because Coe, Helpman and Hoffmaister assumed rather than tested that imports from industrial countries provide the correct weights with which to combine stocks of knowledge in order to reflect importers' access to foreign knowledge. Keller (1996) has suggested that, in fact, the results are little better than would be obtained from a random weighting of countries' knowledge stocks.

A further implication of the Coe, Helpman and Hoffmaister model, if we believe it, is that trade policy that switches a country's imports of machinery and equipment away from the United States and Japan, which have the highest stocks of knowledge, toward other economies, which have lower stocks, may be harmful to the rate of TFP growth. Winters (1996b) explores this possibility for an EU-Lebanon RIA and finds, fortunately, that, provided it increases general openness a little, its net effect will be positive despite the trade diversion. For other RIAs, however, where trade may be diverted to less knowledge-intensive suppliers than the EU, it could be important. The static analysis of RIAs has long observed that trade diversion is potentially harmful. What I have described here is a dynamic version of trade diversion.

**Accumulation**

I have argued that growth results from accumulation. Hence, if RIAs affect the incentives for accumulation they will have at least temporary effects on growth. An early and striking application of this insight is Baldwin (1989, 1992), who models the effects of integration on accumulation to generate a "medium-term growth bonus." An RIA makes trade easier and hence tends to raise the returns to all factors of production. If the cost of capital is unchanged, the response to increasing rates of returns is to invest more and thus to increase the capital stock. This leads to a temporary, but generally long-lived, increase in growth rates as the accumulation shifts the economy onto a higher trajectory. Once the new steady-state level of capital stock has been achieved, there will be higher levels of output per head, but growth will return to its original level. Baldwin (1989) suggests that the medium-term bonus could double or treble the static efficiency effects of an RIA on output.

If we accept the basic model, the first question to ask is whether an RIA will raise or lower a developing country's rate of return to capital. A simple-minded application of the Heckscher-Ohlin model might lead us to expect that the latter would fall in a North-South arrangement. For example, comparing the EU and, say, Morocco, the EU is capital-abundant and Morocco capital-scarce. Since international trade tends to reduce the returns to the scarce factor, increased trade with the EU seems likely to reduce the returns to capital in Morocco. This is a salutary thought, but maybe the basic Heckscher-Ohlin model is too simple for this purpose.

First, it applies only to a so-called square model with equal numbers of factors of production and goods; there is no indication that this is the way the real world is. Second, the Euro-Med Agreement is not a complete liberalization of trade but a partial liberalization, which could have different effects. Third, the Heckscher-Ohlin model presumes homogeneous products, whereas experience suggests that many markets are better represented by a model of differentiated products and intra-industry trade. In the latter case it becomes very important how substitutable domestic and foreign goods are for each other. Building on these
complications Baldwin and a number of collaborators have suggested a number of reasons why one might expect economic integration to raise the rates of returns on capital in both partners regardless of capital abundance. (See Baldwin, Forslid and Haaland 1995, Baldwin and Seghezza 1996a, b, c and Baldwin and Forslid 1996.) I will briefly sketch four of them.

First, an RIA typically reduces the transactions cost on tradable goods more than those on non-tradable goods. If, as is commonly believed, non-tradables are labor intensive and tradables capital intensive, trade liberalization will increase the demand for capital relative to labor, and thus increase the rate of return on capital. Relatedly, increased competition in tradable goods sectors may induce improvements in efficiency and declines in markups in this sector. This will cause increased demand for inputs into the tradable sector, and thus reinforce the effect above.\footnote{1}

Second, an RIA may reduce tariffs and trading costs on imports of capital equipment. This would reduce the prices industry has to pay for imported investment goods, and may stimulate the domestic capital goods industry to greater efficiency and/or less monopolistic behavior, or both.

Third, an RIA that goes beyond tariff reductions could improve efficiency in the financial sector. If this led to reductions in lending margins, it would stimulate investment by reducing the cost of funds.

Fourth, an RIA may improve the atmosphere for investment by inducing greater credibility in the government’s willingness or ability to pursue sound policies.

There is at least circumstantial evidence that RIAs can generate investment booms, as is evidenced in the investment data for the “Six” after the creation of the EEC, the Iberian enlargement of the EC, EC “1992,” NAFTA and Mercosur. Thus there is some support for this as a route to a temporary spurt of growth. However, given the well-known possibilities of rising investment in the presence of other distortions, one needs to be clear that such investment is economically warranted before declaring such RIAs successful.

An important element of accumulation in some RIAs is believed to be FDI. Many economists see inflows of FDI first as harbingers of confidence in the economy, and second as the route through which an economy can modernize—for example, through access to modern technology, modern management, marketing networks and sources of inputs. If inflows of FDI are to be beneficial, such advantages are essential, for FDI is an extremely expensive way of borrowing capital if that is all you get. Also, while FDI might boost GDP, it does less for GNP, because many of the benefits of FDI will accrue abroad. If the local economy is to reap a benefit from FDI, we have to identify the route through which incomes, as well as output, are stimulated. Among the most obvious of such routes are the ability to tax foreign companies (although sometimes governments are prone to forgo this right precisely to attract the companies); benefits to employment if there are pre-existing unemployed resources (but then we need to know why labor that was potentially employable was unemployed in the first place); and spillovers, mainly of the sort which we discussed briefly under the heading of convergence.

The literature on spillovers from FDI is ambiguous (see Blomstrom and Kokko 1997a), but it is fair to say that there is at least some evidence in favor of their existence. FDI appears in many cases to stimulate productivity in local firms. In the same industry as the FDI, this may be due to demonstration effects (local firms see that things can be managed better than they currently are) or a competition effect (local firms are obliged to adjust or go under). In other industries it may reflect forward linkages (other forms using better inputs from the multinational company) or backward linkages (the multinational company’s requiring and helping local suppliers to produce better inputs for all their customers). It may also arise from the mobility of labor as the multinational corporation trains labor and managers who then move on to other parts of the economy. The fact that the multinationals seem to pay efficiency wages—that is, wages above the going market rate—suggests that they are conscious that such spillovers are possible and that it is to their advantage to try to hang on to the skilled workers they have trained.

The evidence suggests that the principal requirement for attracting FDI is sound policies at home—including macroeconomic stability, good labor relations and open borders. One has only to consider China and Indonesia to realize that RIAs are not necessary for attracting FDI, and Greece to realize that they are not sufficient.

A simple RIA may reduce FDI flows between member countries because they make trade a more attractive option. On the other hand, FDI from outside the bloc may increase as foreigners seek to exploit new investment opportunities and to use one member as a platform for serving the whole
bloc. Blomstrom and Kokko (1997b) suggest that while the U.S.-Canada FTA had little investment effect, Mercosur and NAFTA (Mexico) both stimulated FDI inflows. Intra-RIA flows may be stimulated—as, for example, with the EC's Iberian expansion—by flows in non-traded sectors (e.g., several services) and, if they are made, by provisions for capital inflows, the repatriation of profits, and enhanced dispute settlement.

The changing patterns of FDI under an RIA sometimes attract the sobriquets "investment creation" and "diversion." As mere descriptors of rising and falling shares these terms are unexceptional, but then we hardly need new vocabulary for the phenomena. However, as parallels to trade creation and trade diversion, and especially their welfare implications, these terms are dangerous. Advocates of the view that RIAs increase FDI rarely argue that it displaces domestic investment (the parallel with creation) or that member flows displace non-member flows (diversion). Still less, too, do they argue that member flows are less desirable than non-member flows. Moreover, new FDI from any source could go into the production of goods for trade diversion and thus worsen the RIA's welfare overall. Thus, my advice is to drop the terms "investment creation" and "diversion" from our vocabulary and spell out directly the phenomenon we are interested in.

In immediate violation of my own advice, let me identify one very close investment parallel to trade diversion. Rules of origin (ROOs) within FTAs require substantial shares of the value of a good to originate in member countries before the good qualifies for the RIA's trade preferences. This severely handicaps potential investors from outside the bloc who would, at least initially, probably wish to source considerable shares of their inputs from their traditional (non-bloc) suppliers. That is, ROOs give member investors an artificial advantage. If members are less suitable sources of FDI than non-members, we have essentially investment diversion. This might be the case if members are less efficient producers than non-members. Consider, for example, the advantages that U.S. and EU auto producers receive in Mexico and Eastern Europe relative to Japanese firms. It could also occur if member firms offer fewer opportunities for spillovers than non-member firms. The ability of local firms to assimilate information may decrease as the gap in knowledge and experience between partners widens. Thus, for example, Mediterranean producers may learn more from Korean or Taiwanese (China) firms than German ones, but the ROOs in the Euro-Med Agreements will favor the latter.

It is easy to argue that RIAs will generate new investment and, in particular, increased inflows of FDI, but it is difficult to do so with great confidence in either the prediction or its desirability. RIAs have clearly been associated with such changes but to establish the advantages of the RIAs on these grounds one needs to show: that the RIA and not, say, MFN liberalization generated the incentives, that the investment is not immiserising, that spillovers occur, and that "better" investment was not displaced by "worse" investment.

Credibility

A common claim for RIAs is that they enhance policy credibility (Whalley 1996, for example). On the narrow issue of the instruments negotiated under the RIA—e.g., tariffs on intra-bloc trade—this seems reasonable, although one must still consider the incentives and ability for one partner to discipline another. An RIA probably focuses the incentives better than the GATT. Under the GATT there is a large "public goods" element to retaliation—if A retaliates against B for increasing a tariff, (a) other suppliers benefit directly from the lower tariff, and (b) if, as a result, B becomes less prone to such anti-social behavior in future, the likely major beneficiaries are C, D.... Within an RIA the spillover is smaller, being restricted to other member countries. On punishment, if an RIA delivers benefits beyond the WTO in the form of, say, investment, punishment for defection can be correspondingly heavier.

Whether RIAs discipline trade policy toward third parties is moot. Clearly if trade policy is common to the RIA, individual countries have less ability to impose their own barriers, but, on the other hand, any bad policy that does emerge is spread more widely—e.g., Brazil's tariffs on capital goods (see Winters 1994). Where members set their own policies on third-country trade, there is no formal discipline (or spillover), and two offsetting forces are at work. If tariffs on partner imports are fixed at zero, those on other suppliers will be lowered by the incentive to minimize distortions between different sources of imports and raised by the desire to protect domestic output more vigorously against supplies from third parties if one cannot protect it against those from partners. The latter effect depends on goods being differentiated by supplier, but, given this, which effect dominates depends on the degrees of substitutability between different goods.
It is equally difficult to resolve the matter empirically, because the anti-monde for policy is so difficult to define. For example, Mexico responded to the peso crisis of 1994/95 by raising tariffs on 500 items against non-NAFTA suppliers. Bhagwati and Panagariya (1996) see this as diverting protectionist pressure onto third parties. Others argue that previous crises have witnessed far worse protectionism and thus that NAFTA has induced restraint. Bhagwati and Panagariya respond that the intellectual atmosphere is far more liberal now than previously—consider, for example, India—and, less convincingly, that vigorous protectionism such as seen in the 1980s sows the seeds of its own demise, so that by permitting a partial response now, NAFTA could slow down ultimate progress toward multilateral liberalism.

Turning to policies that are not part of an RIA, it is more difficult to see where credibility comes from. Fernández (1997) identifies two possibilities. First, an RIA may raise the cost of macroeconomic laxity because it typically increases marginal leakages to imports, although, as Fernández notes, the RIA also increases the (temporary) returns to competitive devaluation which pushes the opposite way. Second, if entering an RIA entails (political) sunk costs, and if it requires liberal or sound policies to make sense, entry provides the government with a signaling device, for only a government with liberal intentions would sign. Thus, in the presence of asymmetric information about the government's type, an RIA could improve credibility.

I find the last argument a persuasive explanation for the recent interest by governments of developing countries in RIAs. There has clearly been a shift in perceptions of the policy requirements for economic growth, and after several decades of pursuing different policies, governments clearly require means of signaling genuine changes in attitudes. Whether RIAs are the best means of such signaling, however, and whether signaling is sufficient to justify RIAs, is less clear. First, there is an element of circularity in the argument. If an RIA is genuinely liberal—i.e., if it increases domestic competition and creates trade—it is beneficial (relative to the status quo) in those terms alone. Thus, credibility is just icing on the cake. If, however, the RIA is not liberal, it will presumably not induce much credibility. Thus, credibility is, in some sense, not an independent characteristic of RIAs. Second, there are other means of signaling and winning credibility—for example, binding trade policy under the WTO, accepting Article VIII of the IMF, domestic rhetoric, and constitutional limitations. These do not have the trade-diverting risks of RIAs.

To summarize, locking-in and credibility of policy reform do seem to have been closely linked with RIAs over the last few years. And it is true that many countries—not least in Latin America—have liberalized both globally and regionally. However, I doubt that this confers on RIAs an independent ability to grant credibility. Greece has been a member of the EU since 1981 and yet subject to serious macroeconomic shortcomings, showing that RIAs are not sufficient for sound policy and hence presumably not particularly good sources of credibility in themselves. Hence, overall, if we are to believe that a prospective RIA enhances a government's credibility, I believe we should spell out clearly why and how.

**Location**

A major issue in RIAs among developing countries has been the location of industry, often loosely equated with the location of the benefits of integration. Indeed, in previous decades, when governments felt they could and should manage location, this was sufficiently contentious to destroy some RIAs. Now governments profess greater faith in the market to distribute industry efficiently, but they still worry about outcomes and wonder whether they can nudge the process their way. Recent analysis has suggested that there may be some truth to worries that RIAs and the deepening of integration within them could lead to some regions losing, or at least failing to gain. These analyses depend on the interactions between economies of scale and transactions costs. Krugman and Venables (1990) provided the first, very elegant, example, which showed how industry's preferred location between a high-cost large-market "center" and a low-cost small-market "periphery" would vary with transactions costs between them. Briefly, at very high (prohibitive) transactions costs, industry locates in both places just in order to serve both. At intermediate costs, it is feasible to trade, and if scale effects are strong enough, it pays to concentrate production in one place and export to the other; obviously if it is not too much more expensive in production terms, firms choose the large-market center because there they avoid transactions costs on the larger part of their sales. At zero transactions costs, location is determined solely by production costs, so now firms prefer the low-cost periphery for all their production.
This model had a salutary effect in simply disproving the notion that low-cost peripheries would automatically attract industrial activity. However, it offered little practical guidance for predicting the effects of RIAs. First, it was partial equilibrium in nature—costs of production were independent of the volume of industry. Second, the exercise is comparatively static; it does not actually refer to firms relocating. Third, we have no idea whether the irreducible minimum transactions cost between two countries—perhaps best thought of as that between two states in the United States—is high, low or intermediate. Brulhart and Torstensson (1996) have found suggestive evidence for the EU that industry has concentrated and along the lines predicted by Krugman and Venables, but, on their own admission, it is not strong.

Economic geography has advanced a lot since Krugman and Venables, but it is still a long way from producing testable or quantitative predictions because the models it uses are so far removed from reality. Among the most relevant advances are by Puga and Venables (1997a, b) who have a model in which industry is both attracted to large markets to avoid sales costs and repelled from them by their higher production costs. They use this in the latter paper to explore how industrialization in two identical developing southern countries might be affected by various forms of integration arrangements. Among their conclusions are that even if the two countries liberalize their trade at the same rate, they will take off at different times, because, at low levels of southern industrial development, agglomeration economies make it inefficient to split industry between two sites. Although eventually both developing countries fare the same, there are clear benefits to being the first to industrialize in discounted terms. Moreover, the lagging developing country can actually lose before it industrializes itself. Thus developing countries are at least partly competing against each other.

Puga and Venables also suggest that while unilateral liberalization by a developing country stimulates its industrialization, signing an RIA does better (for the member developing country). While precise results depend on parameter values and the level of remaining trade costs, about both of which we have almost no information, their results suggest that North-South RIAs dominate South-South RIAs. Multilateral liberalization dominates all options for a developing country except for a North-South RIA outside which the excluded developing country refuses to liberalize.

These models are stimulating and challenging, for they capture better than most the common perception that countries compete and that development can be uneven. However, they do not yet constitute practical tools for predicting the effects of RIAs, for they lie so far from measurable reality. Thus while it is now clear that an RIA could have locational effects we are not able to predict these ex ante nor, with confidence, identify them ex post.

**Politics**

Regional Integration Agreements are frequently argued to be an important element of diplomacy. The classic case is the precursor to the European Economic Community, the European Coal and Steel Community, 1951, which was explicitly seen as a way of reducing Franco-German tensions—making war not only unthinkable but materially impossible. Similar objectives are said to be present, if not so centrally, in Mercosur and ASEAN. These cases raise at least two sets of questions: Why use trade as the diplomatic tool? And what implications does this have for the RIA itself?

On the latter, Schiff and Winters (1997) have recently offered a theoretical analysis. Taking as given the premise that trade increases understanding and harmony between partners, they show that an FTA could be an optimal policy if actors value these things. They also show that as the FTA grows, and if it pursues deep integration, the optimal degree of preference for intra-bloc trade decreases. This translates into declining external tariffs—exactly the pattern observed in the EU. They also examine the optimal degree of preference as a bloc widens its membership. There is a weak presumption that this too could lead to declining tariffs, but this is easily overturned by changes in particular circumstances.

On the question of why use trade diplomacy—i.e., whether trade is the appropriate or optimal tool—little analysis exists. Mansfield (1993) relates politics and RIAs, but with the former "causing" the latter and a requirement (for his argument to make sense) that the RIA be welfare-enhancing. Fawcett and Hurrell (1995) also see causation running in this direction, with RIAs as part of the response of nation states to the erosion of their power by globalism. That is, states pool sovereignty in an RIA in order to achieve sufficient leverage to manage global pressures. From this perspective it is not clear whether RIAs are desirable for developing countries, for it is not clear that
managed solutions are better than just accepting the role of a small open economy.

In the case of European integration Milward, Brennan and Frederico (1992) have advanced similar arguments. These clearly have some validity, for Europe has generated material economic power in those areas in which it can act in a concerted fashion. One should also observe, however, that in the European case several other forms of diplomacy/integration were tried and failed—e.g., the Political and Defense Communities in the 1950s. Thus, in a sense trade diplomacy was all that was left.

The political dimension of RIAs does seem an important one, but one over which the analyst needs to exercise caution. Cooperation without tariff preferences seems perfectly possible if one wishes it, and free trade does not guarantee peace. Witness the American Civil War, which was partially caused by disagreements over trade policy. Thus, to justify an RIA on political grounds one needs to show how preferences contribute to the political rapprochement and to show that such a rapprochement is valuable. The latter requires (a) that rapprochement is real and (b) that it would not have happened anyway.

**Conclusion**

The body of this paper has identified several potential benefits from RIAs and a few possible drawbacks. The challenge is not in thinking up how RIAs could be beneficial, but in offering convincing reasons why they *will* be or have been. I have argued elsewhere (Winters 1996a) that, as well as generating trade diversion, regionalism can be harmful in terms of arresting progress toward liberal multilateral outcomes. Hence, while they may well provide benefits relative to the status quo, RIAs also entail a potential downside risk.

In discussing RIAs I believe that there is no alternative to the careful exploration of the various sources of costs and benefits. By this I am most definitely not saying that we should conduct careful trade creation and diversion exercises and ignore everything else on the grounds that it cannot be measured. Rather, we owe it to each other to spell out the benefits that we have in mind and their channels of causation, so that their bases can be discussed and examined explicitly. Even if we cannot quantify and add up the various effects, we can at least be clear and identify areas of agreement and disagreement. I hope this paper has helped us to do this during the rest of this conference.

**References**


**Notes**

1. This is not saying that countries ignore the effects of their policies on other countries, only that the feedbacks via systemic effects are so small and uncertain that few small- or medium-sized countries will internalize them in policy decisions.

2. It is true that all policy advice occurs in a second-best context, but in other areas the connection, or degree of interaction, between the remaining (immovable) distortions and those whose removal is being contemplated is rarely as close as that between, say, tariffs on wheat imported from Argentina and wheat imported from Canada. Thus, generally speaking, second-best is a bigger problem in discussions of RIAs than elsewhere.

3. The force of this argument was brought home to the author when trying to explain the limitations of the first Europe Agreements to a meeting of senior officials and negotiators from the EU and the Visegrad countries just after negotiations had finished. The reception was universally and vigorously hostile, despite the fact that, subsequently, many of the problems forecast arose and the Agreements were modified. See Winters and Wang (1994, Chapter 3).

4. There is some dispute about what Viner actually said—see McHarry and Viner and the references therein in the *Journal of International Economics*, February 1976.

5. Also note that Wonnacott and Wonnacott's gains depends only on there being transport costs on the rest of the world, not, as they claim, on the relative size of these and intra-bloc transport costs (Amjadi, Winters and Yeats 1995).

6. I discount an early effort by Harris (1986) because it failed to provide a coherent view of imperfectly competitive pricing. See Winters (1992).

7. The loss of imports is matched by a loss of exports, so the welfare loss arises from the (small) loss in the efficiency of transforming one into the other, not from the loss of the whole bundle of imports.

8. Models of differentiated products all predict price effects (because all demand curves are downward sloping), but this has not yet been exploited empirically.

9. This statement is true of simple cases with constant returns to scale and no other distortions. Once these are introduced, deep RIAs can be harmful—see, for example, Haaland and Wooton (1992) and the section on dynamics (subsection on location) where costs and economies of scale interact. It is also true that where deep integration involves harmonizing standards or policies, they need to be harmonized at "sensible" levels if doing so is to be beneficial.

10. Also, signing a Europe Agreement has been the signal for the EU's treating an eastern partner as a market, rather than a non-market, economy. These issues are not formally linked, however, and are also conceptually separate.

11. Mazumdar (1996) shows a similar problem if liberalization favors the labor-abundant commodity.

12. In the case of efficiency increases, this effect depends on the elasticity of demand being high enough to increase demand by more than efficiency improvements reduce the inputs required per unit of output.

13. This section draws freely on Fernandez (1997).

Comment

ROBERT DEVLIN

This is an excellent paper, which critically reviews what has been done in the area of integration and how it has been done. In the introduction of his paper Alan Winters states that his objective is not so much to make an assessment of regional integration as such, but rather to focus on "how" one might go about making such an assessment and also to provide directions for future research. I would like to concentrate my very limited time on this central issue and make some practical suggestions.

Evaluating regional integration processes and their costs and benefits is no easy task. Part of the problem is the nature of the subject matter.

First, regional integration is a complex general-equilibrium phenomenon with dynamic processes, making it difficult to dissect causal explanation. As Alan points out, the process involves issues that link growth to technology, learning, externalities, political economy and politics, all of which economists have trouble grappling with at a national level—not to mention among several countries simultaneously. A further serious complication one finds in Latin America is that the integration processes are an integral part of profound structural reforms that have touched virtually all levels of the economy and create big changes. Moreover, initial conditions, and the phases and sequencing of these reforms, are usually quite different among the partner countries of an integration agreement.

Second, regional integration is a medium- to long-term process. When successful, one expects to see initial costs compensated by benefits that play out over the medium and long term.

Third, as Alan points out, regional integration is very much a second-best world where generic prescriptions can be especially dangerous.

These characteristics place great burdens on analysts. Regional integration is often evaluated in light of what would have happened in its absence. Moreover, economists are interested in measuring changes in welfare (i.e., being better off); given the complications of defining this for a particular subregion, they often use a proxy expressed in a summary statistic reflecting growth or trade.

However, it is well known that counterfactual analysis faces a daunting epistemological problem: Contrary to fact conditionals can never be verified by realizing their antecedent (the "if" clause); thus, the resulting explanation is never correct or incorrect, but rather only persuasive or not persuasive.

We also know that counterfactuals are more likely to be persuasive: (a) the more simple the causal process studied; (b) the shorter the time period in question; (c) the smaller the changes considered; and (d) the less analysis turns on exact magnitudes. Reflecting back on the characteristics of our subject matter, one sees that counterfactual analysis of integration is challenged on all these counts.

Robert Devlin is the Chief of the Division of Integration, Trade and Hemispheric Affairs of the Inter-American Development Bank.
Another problem is that conclusions about integration rarely are based on the entire story. Much of the debate centers on the static trade-creation and trade-diversion effects first pointed out by Viner. This is partly because many economists consider these effects to be the fundamental dimension for evaluating regional integration. One problem, however, is that the static analysis frequently uses a partial-equilibrium framework to jump to general conclusions about a process that is a general-equilibrium phenomenon. Worse, the mere existence of trade diversion alone in the new integration agreements (never mind the net effects with trade creation) has sometimes been the basis for categorically negative evaluations of a regional agreement, and regionalism more generally.

More importantly, trade creation and diversion is clearly only part of the story, and many other economists would argue that it is not the major part. This is because the net benefits of the dynamics of integration are suspected to be several times larger than their static reallocation effects. Problems exist here, too, because our models of dynamics and empirical foundations for testing them are very deficient, so much so that Alan has characterized analysis in this area as “mystical.” It is true that the empirical foundation of dynamic analysis is still weak. Nevertheless, the models of dynamics are sufficiently specified to suggest that the benefits behind the dynamics of integration are potentially large. Therefore, it is worth the effort to go beyond static trade creation-diversion analysis (which has its ambiguous dimensions as well) to begin to better understand, even if only very imperfectly, the longer-term dynamics.

The empirical bottlenecks to understanding Latin American integration should not be underestimated. Even basic data such as the evolution of preferences, rules of origin, non-tariff measures, intra-regional investment flows and firms’ cost structures, etc., are unavailable or incomplete. The many gaps sometimes induce questionable ad hoc compromises in our analytical techniques or cause us to ignore phenomena altogether through the convenient use of ceteris paribus. Better data development and more field research will not eliminate the debate over regionalism, but it would certainly help to ground the debate more in reality, and it probably would help narrow our differences.

The starting point is to better complement our powers of scientific deduction with much more empirical field work and case studies of the disaggregated dimensions of the dynamics of regional integration. In other words, in our present state of ignorance of Latin American integration, instead of examining what would have happened in the absence of integration, we might want to spend more time discovering what is actually happening and how it is happening. In effect, one would examine the different objectives of a specific integration arrangement, assess whether these different objectives are being realized, and begin to catalogue the causal factors contributing to developments, without necessarily being overly concerned about precise weights. For example, one frequently stated objective of regional integration is to enhance competition; hence, we can examine how sectoral markets are changing their competitive structure and the forces behind that. Is intra-industry specialization increasing in the subregional market? Are the different parameters of the integration agreement stimulating firms to invest? Are firms’ technology and cost structures improving in the direction of greater international competitiveness, and is there room to reduce preferences? Are new international exports and comparative advantages emerging out of experiences in the subregional market?

This type of research is at “ground zero” and examines the integration agreement from the bottom up. Field research does not generate elegant and timeless analytical structures. It is time-consuming and expensive, often requiring the building of primary data bases. It also will not generate summary statistics of welfare or permit categorical evaluations of integration processes. Nevertheless, it has four potential benefits:

1. It will allow for better observation of what is actually happening in the different dimensions of integration. The analyst gets “inside” the process where the action is and examines the dynamics of sectoral markets and firms that actually move the process forward.
2. By working at relatively low levels of aggregation one might be able to identify causal factors that are not easily captured in existing theory or more aggregated analysis.
3. While such analysis will not permit the adding up of effects into a summary statistic of welfare, the examination of multiple disaggregated dimensions of an integration process will permit a series of analytical vignettes that, taken together, can build a tentative picture of whether the integration process at least is moving in the direction of achieving its goals in strategic areas.
4. The empirical work will feed our economic modeling of integration with better informed assumptions and better data for testing.

In sum, this approach does not suggest that we abandon modeling and counterfactual analysis, which are key tools of our profession. Rather, it suggests that more intensive interaction between deductive and inductive methods will enhance our powers of discovery and evaluation of a process that is ever more present in the world economy.

Until we have a better ability to measure and evaluate the full story of integration, we should be careful about our conclusions. Any major transformation has costs, usually concentrated up front. Therefore, it is no surprise that integration has costs. For instance, regional integration is a strategic compromise among different countries in different economic conditions; for this reason trade diversion is hard to avoid, and the initial redistributive effects from lost tariff revenue can be important, especially in North-South agreements such as NAFTA. However, countries justify these costs by the greater benefits that are expected, which are spread out over a longer period of time. When examining these up-front costs, analysts should be careful to interpret them as only a piece of a story that plays out over a longer term, and should refrain from categorical overall assessments, except in the most extreme cases. Meanwhile, since regional integration is a strategic decision, participants should have their objectives clearly articulated. One objective is to minimize costs; thus, any constructive analysis that sheds light on them also should be welcome. Moreover, vigilance about costs is extremely important. On the one hand, while fashionable, not all integration arrangements make economic sense. On the other hand, even those that do can potentially go awry.

Finally, a word about semantics. As Alan points out, words often carry labels; for example, “discrimination” (bad), “neutral” (good) and “natural” (good). However, in a second-best world, one should be careful about placing a priori normative labels on our terminology. Discriminatory policy can be good or bad depending on the circumstances and its effects. For instance, areas dense in capital and population tend to invest and specialize relatively intensively. If such areas have activity truncated by borders and other transactions costs, it may be useful to use discriminatory preferences to accelerate commercial interaction and capture the externalities of location and agglomeration. It is true that this might occur anyway, but it may be at a slow and uncertain pace with costs for delays. Neutrality sounds good, but since initial conditions among countries may differ, some discriminatory policy may be justified to avoid a potentially destabilizing or inequitable distribution of gains. Natural market forces sounds good, but we know that these can lead to bad things such as monopoly, which can cause a society to discriminate against successful firms.

In sum, Alan’s warning about the power of language is certainly another useful suggestion for assessing regional integration.
Comment

RICARDO FFRENCH-DAVIS

It is a pleasure to be here and to have the opportunity to comment on the paper by Alan Winters. It is an excellent paper, well balanced, that surveys many issues related to regional integration. He emphasizes the need of making explicit the benefits and costs of regional integration; actually, anybody who does economic policy should try to make some sort of measuring of the benefits and costs of any economic policy. It is difficult, but one should try to think about what one is building with economic policies, and that, of course, includes regional integration. We should try to be the most rational possible, given the limitation of information and the complex issues we are dealing with.

I want to make three points of strong agreement with Alan Winters. Then I will present five points that I think bring forth a balance in favor of regional integration, but with some qualifications, on the road to a global economy.

The three points of agreement: The first is related to trade creation and trade diversion. I agree that they are merely indicative, rather than definitive concepts. As he says, it is risky to jump to economic welfare conclusions. They are useful indicators, but we have to go beyond that. Creation is not completely positive, and diversion is not completely negative (with a little bit of positive effect in the consumer level). There is much more beyond them. I would like to add that we know that trade creation may have negative effects in the transition, if it is abrupt, and diversion may end to be positive under cost-reducing economies of scale and learning-by-doing.

The second point is that we must go beyond trade itself. We must not measure the quality of trade policy simply by what happens directly on trade. We should look more broadly—to economic welfare. For instance, it is a fact that exports grew vigorously in Latin America in the 1980s, 7 percent (quantum) per year on average. That is 1.5 times faster than world trade in that period. However, GDP growth was only 1.6 percent. It matters how exports were fostered and what sort of exports were growing—not only the quantity, but the quality of exports.

Let us try to move toward the effects on economic welfare and not take a given reform at face value, whether it is PTAs, unilateral import liberalization or other reforms. The relevant question is whether they represent inputs for economic welfare growth. In our area of concern today, how do unilateral trade liberalization and PTAs affect the sources of growth?

Third, growth depends on accumulation of human and physical capital—combined with more efficiency in a framework of more complete markets. One of the problems of developing economies is that they have several missing markets. Markets of knowledge, labor training or long-term capital are incomplete or are missing in many economies. So we have to build those markets, or simulate or complement them. We will argue below that some sorts of regional integration can help to build some of these mar-

Ricardo Ffrench-Davis is a Regional Adviser in the Office of the Secretariat of the Economic Commission for Latin America.
kets, PTAs being in some relevant cases superior to unilateral liberalization.

The five points that I will mention, with analytical and policy implications for PTAs, are associated with incomplete markets, cost of information, a role for generating systemic competitiveness and within that for the acquisition of comparative advantage. So let us see these points and the framework within which we place them.

**Analytical Basis for PTAs**

Deep trade reforms have been undertaken in the Latin America and Caribbean Region (LAC) as part of a broad-ranging process of change, in which international competitiveness and exports play a leading role. Most countries are seeking an export-led development. Nonetheless, in contrast with the experience of East Asian nations, the main instrument of trade reform has been a rather indiscriminate and rapid liberalization of imports (see Agosin and Ffrench-Davis 1995; ECLAC 1998, Chapter V). Most countries in the region introduced reforms that could be described as drastic and sudden. Generally speaking, the tariff protection provided at present differs considerably from its pre-reform levels, and the spread of rates of effective protection have diminished substantially. For instance, the simple average external tariff was reduced from 45 percent by the mid-1980s to 13 percent today. No country has yet adopted a zero tariff rate. These regional trends in trade policy have been complemented by a drive toward implementing bilateral or multilateral free-trade agreements, covering a wide spectrum of items. The fact that tariffs are different from zero but with moderate levels leaves space for reciprocal tariff preferences but with more limited trade diversion than in earlier integration programs.

The conventional literature on the benefits and costs of economic integration focuses on tariff preferences in a framework of optimal competitive equilibrium. This equilibrium is assumed to be disturbed only by the existence of import restrictions. In this framework, integration is beneficial only if it implies a move toward free trade—that is, if the effects of trade creation (shift toward cheaper sources of supply) are larger than those of trade diversion (shift toward more costly sources of supply). The crucial issue, however, is how costs are measured; in the standard approach it is at actual market prices net of tariffs, assuming away transitional costs and incomplete markets, as well as acquirable competitiveness. The assumptions lead to the obvious conclusion that overall unilateral liberalization is the optimal national policy and better than any PTA, particularly among developing countries.

Why, then, do so many nations want to be involved in integration processes, even in these times of fashionable free trade? Regional integration builds on strategic considerations arising from imperfect and incomplete markets at home and abroad, which handicap the spread of efficiency gains in certain sectors and the development of new productive patterns with progressively higher degrees of value added. The five issues that follow, related to trade in goods and services, provide analytical bases to support regional integration arrangements with preferential import regimes. One crucial assumption we adopt is that regional integration takes place in a framework of open regionalism, with “moderate” external tariffs.

**First**, world markets are not widely open and stable. Nonetheless, they are broad, growing 50 percent faster than GDP in the last half century, and reaching one-fifth of world GDP. They are dynamic, but not completely open and stable. On the other hand, LAC’s exports are concentrated in natural resource-based primary and semi-manufactured commodities. Thus, with or without participation in PTAs, world markets have been and will continue to be crucial for LAC’s traditional exports; instability actually prevails in those markets, but it refers more to prices than to access (or volume). However, for many nontraditional products (including nontraditional natural resources), access to markets is more limited and unstable. These other products tend to be a crucial part of the growth process, and, actually, they were very significant in the development drive of East Asian nations. It is for these type of products that PTAs become relevant to foster a diversifying growth of exports.

Regional integration can be important for these nontraditional products, locking in better access to markets. It can be a device to foster a diversification of exports, toward output more connected to overall competitiveness of our economies.

**Second**, given those distortions or restricted access in world markets, economies of scale and specialization are more difficult to secure for a country or producer in the process of learning to export. To lock in improved access to regional foreign markets helps to make use of those economies, and in fact this achievement has been a leading target of policymakers and a force encouraging regional integration. As a consequence, in the face of economies of
scale, what otherwise would be a costly trade diversion can become a cost-reducing and welfare-enhancing trade diversion (Corden 1972; Ffrench-Davis 1980).

Third, domestic factors markets are incomplete or distorted. Labor training, technology and long-term capital are scarce, with nonexistent or infant markets in LAC. These market failures are more significant for nontraditional exports of differentiated products, whether of natural resources, manufactures or exportable services. These markets have been improving, but they are still quite far from maturity. If access to external markets is improved for the exportables intensive in those ingredients of development, it can strengthen the effectiveness of efforts to complete markets and dilute segmentation.

Nontraditional exports, differentiated products and products more value-added and intensive in knowledge are more typical of the export basket to regional integration than the export basket to the rest of the world (see ECLAC 1998, Chapter III).

Fourth, infrastructure, trade financing and knowledge of markets (marketing channels, organized transportation, standards, etc.) are often biased against intra-regional trade in LAC. All these special “factors” of trade traditionally have been more developed for deals with the “center” while they are nonexistent or more rudimentary for trade among LAC’s neighbors. This is a significant variable explaining why intra-regional trade has been lower in LAC than what the gravity of geography suggests. Thus, PTAs can help to put things in a more competitive stage by removing these unnatural, artificial obstacles to reciprocal trade, being a second-best, efficient move toward the potential frontier.

So, preferential treatment in regional integration might help to leave the gravity of economy to operate more naturally.

Fifth, in economies like those in LAC which have been reforming trade policies, sliding away from excessive and arbitrary protection for import substitutes and inputs of exportables, there tends to emerge significant transitional costs. These are enhanced if the exchange rate happens to appreciate, as it has been the case in most LAC countries in the 1990s.

East Asian nations minimized transitional costs in the 1960s and 1970s with an export-led strategy for opening to the world economy (see Agosin and Ffrench-Davis 1995). That is, in their opening processes, nations like Japan, Republic of Korea and Taiwan, China put a stronger emphasis on export promotion than on import liberalization; thus, in the transition period, they provided a net positive balance of pulls for the domestic output of tradables (encouraging use of capacity, and of investment to increase that capacity). Given LAC’s option for an import-led reform, a parallel process of regional PTAs becomes more attractive, in order to increase the efficiency of the productive transformation (ECLAC 1995, Chapter V). In fact, PTAs add a compensatory ingredient to unilateral import liberalization (and more so if the exchange-rate had appreciated in the process), fostering reciprocal exports in tandem with reciprocal imports. Hence, the doses of positive and negative pulls (impulses) to economic activity and investment are more balanced with PTAs than is the case in pure unilateral import liberalization.

All the restrictions are severe obstacles to the expansion of production, and trade in goods and services relatively more intensive in knowledge content and longer learning curves, elements which are now recognized as key components of the growth process. Regional integration can be a strategic tool to partially overcome these obstacles (see Devlin and Ffrench-Davis 1998) by:

- Expanding market size to facilitate greater specialization and industrialization through economies of scale and possibilities to exploit economies associated with the agglomeration of productive activity;
- Enhancing the forces of competition, enlarging a market with guaranteed reciprocal access and intensifying the specificity of information flows, all of which in turn should induce new domestic investment and permit better conditions to attract efficient foreign direct investment (FDI);
- Creating the security of subregional market access and exploiting the familiarity of neighborhoods, which combine to accelerate the emergence of new producers and traders of nontraditional exports. In fact, the learning curve associated with experience in subregional markets can serve as a platform for new international exports. The expected enhanced international competitiveness, brought about by regional integration, should build confidence and prepare countries for globalization and further advances in multilateral liberalization.

**Intra-Regional Trade**

Total intra-regional exports almost tripled between 1990 and 1996. Initially it was principally a recovery from the
sharp drop of the 1980s. However, given a notably rapid growth, shortly the prior peaks were reached. A record was achieved in 1992, with an additional jump in 1993–94. Subsequently, the Tequila crisis transitorily reduced the share of intra-regional exports, particularly those to Argentine and Mexican markets. Nonetheless, Mercosur shows a persistently rising share of reciprocal trade among partner countries: it jumps from 9 percent in 1990 to 21 percent in 1996.

To appreciate the strategic dimension of integration, it is necessary to examine the profile of intra-regional exports. Intra- and extra-regional exports from Latin America display marked differences in their product structure and technological content, with manufactures accounting for a much larger share of intra-regional commerce, as shown in the table below.

The profile of intra-regional trade contributes to a drastic change in the composition of LAC's exports: The predominance of primary exports was partially replaced by manufactures, which now account for one-half of intra-regional trade. This notable increase in manufactured exports corresponds especially to new industries, including both labor-intensive and capital-intensive activities. It is highly relevant to notice that border trade (with neighboring countries) represents the bulk of the intra-regional trade, a new proof that geography matters (Devlin and Ffrench-Davis 1998).

To sum up, intra-regional trade, because of its characteristics, complements LAC's linkages with the global

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<th>Latin America: (14 Countries)*: Composition of Exports by Destination, 1970–74 and 1995</th>
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Source: ECLAC (1998), Table III.9, on the basis of official data.

* Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Mexico (excluding maquila), Paraguay, Peru, Uruguay and Venezuela. Exports with low technological content are summed up with traditional industries.
economy and provides a dynamic context of technological apprenticeship, leading to greater international competitiveness and a more diversified, balanced pattern of specialization. We are in the middle of straightforward open regionalism (ECLAC 1994).

References


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III. Andean Pact
Trade Flows in the Andean Countries: Unilateral Liberalization or Regional Preferences?

JUAN JOSÉ ECHAVARRÍA

LATIN AMERICA DID IN 10 YEARS “THE EQUIVALENT OF ABOUT FIVE GATT ROUNDS, SIX Gramm-Rudmans, and more deregulation than had been accomplished by the Carter and Rea- gan administrations together” (Williamson 1990, p. 356). Tariffs were slashed, quotas elimi- nated, labor and financial markets deregulated and government-owned business privatized. Important complementary reforms were adopted in such areas as infrastructure and foreign investment.

The drive toward “open regionalism” was always seen as another central element of this broad strategy, and it adopted two related paths. On the one hand, great efforts were made to reintroduce trade and com- petition as the key variables behind healthy integration (de-emphasizing industrial planning and sectoral development). On the other hand, new agreements were signed with other countries and regions (i.e., with Mexico, Chile and CARICOM), promoting additional trade and reducing trade diversion in the region.

...
The next section briefly describes the relative (that is, compared with other Latin American countries) depth and characteristics of the unilateral reforms adopted in Bolivia, Colombia, Ecuador, Peru and Venezuela in the financial and labor markets, and in the areas of taxes and privatization. It reviews the depth and speed of trade reforms.

The third section presents a brief history of the main institutional developments in the Andean Group, the characteristics of the Common External Tariff (CET) signed in November 1994, and the process of regional liberalization that took place between 1990 and 1992. The Andean countries created "the most sophisticated integration scheme to foster import substitution at the regional level (and with the most complex set of regulations to implement the agreement)" (Nogues and Quintanilla 1992, p. 285) which, of course, never worked. Among the reasons for this failure are that the goals were extremely ambitious, the countries were poor, and intra-regional trade represented less than 2 percent of total trade at the time. Industrialization became the main—really the only—goal of integration, and industrial planning was considered to be the ideal mechanism to compensate the small countries for their lack of new industry.

Chile withdrew in 1976, and liberalization agreements were systematically violated by the remaining five partners during the 1980s. It was initially thought that more import substitution and protectionism was needed (Nogues and Quintanilla 1992, p. 285), but it was soon realized that those "minor" reforms were worthless; a whole new strategy was required. "Open regionalism" was implemented after the end of the 1980s. Trade and competition were seen as central channels to increase welfare, especially for the small countries; industrialization was the result and not the main factor behind economic growth.

It was easier to agree on common objectives in this new scenario. It is no coincidence that countries signed the CET and dismantled all regional exceptions during the 1990s. The goals of the Cartagena Agreement had been finally achieved after a delay of 12 to 15 years.

The second part of Section III considers the characteristics of the CET and of those exceptions to regional liberalization in place before 1990. Tariff preferences certainly decreased during the period 1986–95 (and 1990–95) with a huge reduction in tariff (and para-tariff) levels. The exceptions dismantled were also important, but did not change the whole trend produced by unilateral liberalization.

Trade flows were very dynamic in the period 1986–96, especially trade in manufactures, with a large geographical reorientation toward the Andean markets in 1990–95. The fourth section offers a brief presentation on the main characteristics of trade flows in the region; it shows that the effect of unilateral liberalization with regional preferences was important in 1993–95, increasing Andean trade by a maximum of 60 to 80 percent. Interestingly, the exercise based on the so-called "gravity" equation, does not support Yeats's contention that trade expansion in Mercosur was artificially created by regional preferences. The section also shows that trade creation significantly dominated trade diversion in 1986–95 for all sectors in Colombia and for most of them in Venezuela. It specifies import functions and suggests that the rise in regional trade flows was determined by unilateral liberalization rather than by regional preferences.

The final chapter of this paper further characterizes Andean trade flows in terms of the level of intra-industry trade (IIT), revealed comparative advantage (RCA) and labor skills. The participation of intra-industry trade increased to levels close to 40 percent in regional trade, which suggests that the adjustment to large changes in trade flows took place inside the firms and did not imply large realignments in domestic production. We also show that the most dynamic exports to the region took place partially because of geographical reorientation, but that they were not especially far from the "average" in terms of capital intensity or revealed comparative advantage.

**Unilateral Liberalization**

**Broad Reforms**

Sebastian Edwards (1995b) considers that the fundamental forces behind the economic policy shift were mainly "local," rising from "the soul-searching that began in Latin America in the early 1980s." This, in turn, was partially caused by the failure of the heterodox programs implemented in the mid-1980s, the example of the East Asian countries with outward-oriented policies and the reinterpretation of the Chilean experience. We should not forget that Latin America's participation in world trade had been decreasing decade after decade, from levels rising from close to 11 percent in 1948 to less than 3 percent in 1990 (Norheim, Finger and Anderson 1993).

Stephan Haggard (1995) gives a larger role to "external" forces like the international debt crisis of 1982 and the
policies of the international financial institutions. All of these forces played a role, but it is likely that "local" forces played a larger role in the Andean countries in their condition as "latecomers." The average debt-to-GDP ratio was 0.9 when the early and second-wave reformers (Edwards 1995a, Table 1.1, pp. 2–3) undertook their reforms, and 0.54 when the third-wave reformers adopted theirs. Obviously, lower debt ratios reduced the leverage of the international institutions. Debt and external forces were not the main factors behind the new policies adopted in Venezuela, where reforms started in 1989, Colombia (1990–91), Ecuador (1990) or Peru (1991). Instead, innovative ideas were forcefully pushed by newly elected presidents and by technocrats.

Lora and Barrera (1997) argue that the structural reforms of the last decade increased Latin America's per capita income 12 percent, and that the average growth potential of GDP in the region would have been only 1.9 percent without the reforms. It is also likely that with the reforms trade will regain some of the importance and impact it once had (see above).

The deepest reforms occurred in the realm of trade and finance. Multiple exchange rates were dismantled, and most restrictions on capital flows and requirements for the repatriation of export revenues were eliminated. The average differential between the market price of foreign exchange and the official rate was 2 percent in 1995, as compared with 72 percent in 1989. Venezuela was the only Latin American country that reversed the exchange-rate liberalization process, doing so temporarily in 1994. The Andean countries again get a combined grade of 3.4, better than the grade for the Central American Common Market (CACM, 2.7) and Mercosur (3.1), but worse than for NAFTA (4.4), Chile (4.4) and CARICOM (3.7). Venezuela (3.9) does a little bit better, and Peru much worse (2.1) than the other three countries (3.7 for Colombia and Bolivia; 3.4 for Ecuador). Schott and Kotschwar (1996) repeated the exercise for more recent years with a large improvement of the grades given to Peru after its reforms in 1992. Rajapatirana (1998) finds some negative aspects of economic policy in Colombia in 1994–97, mainly in the area of trade, with increased protection for agriculture and more use of anti-dumping policies.

**Tariffs**

Figure 1 summarizes the evolution of trade-weighted border taxes (tariffs and para-tariffs) in the Andean countries.
between 1986 and 1995, the solid line representing the level of the CET. Information is also provided on tariff levels in 1995 for Bolivia and Peru, the two countries that did not sign the CET (see below). Table A-1 (in the Appendix) gives additional information on the number of tariff levels and the standard deviation of border taxes and tariffs.

Total border taxes decreased in the Andean Group from 36 to 37 percent in 1986–88 to less than 12.8 percent in 1995 (because of the CET’s Decision 370), the initial levels being much higher in Peru (64 percent) and Colombia (45 percent) than in Ecuador (32 percent), Venezuela (26 percent) or Bolivia (21 percent). This is consistent with the view that, with the exception of Bolivia, the Andean Group countries were “late-comers” in shifting economic policies. On the other hand, trade reforms were completed in less than three years in most cases, which means that the speed of trade reforms was faster than in many other Latin American countries.

Dispersion was also reduced drastically. In 1986 there were 73 border-tax levels (46 tariff levels) in Peru, 61 (36) in Ecuador, 54 (45) in Bolivia, and 41 (41) in Venezuela, compared with the three or four levels for the CET. The standard deviation decreased year after year, from levels that were particularly high in Ecuador and Venezuela. The maximum level reached by total border taxes in 1986 was 169 percent in Ecuador, 138 percent in Peru, 135 percent in Colombia, 113 percent in Venezuela and 38 percent in Bolivia. The maximum tariff was reduced to 35 percent with the adoption of the CET.

All countries, except Venezuela, had important paratari, “disguised” border taxes before 1992, representing 84 percent of the official tariff in the year in which they were definitely removed in Bolivia (1986), 63 percent in Colombia (1988), 56 percent in Peru (1990) and 24 percent in Ecuador (1992).

Did tariffs increase as a result of the adoption of the CET? We will explore this issue further in the section below, but the global averages contained in Figure 1 suggest that changes were rather small. Tariffs did not increase in Venezuela, and increased only marginally in Colombia (from 11.0 percent to 12.8 percent) and Ecuador (from 10.1 percent). Bolivia did not adopt the CET, and Peru
will do it only in the year 2006. Again, we must emphasize that the average tariff adopted after the signature of Decision 370 could be lower since, according to the agreement, countries could adopt lower tariffs for goods not produced in the region.

Information on quotas and non-tariff barriers is always difficult to gather and evaluate, although it is clear that they were pervasive during the 1980s in most Latin American countries. Thus Edwards (1995a, Table 5.2, p. 126) shows that in 1985–87 non-tariff barriers covered 73 percent of imports in Colombia and were also widespread in Ecuador (59 percent), Peru (53 percent), Venezuela (44 percent) and Bolivia (25 percent).

We do not know much about the global or sectoral effect of import restrictions on protection, but the scarce evidence seems to suggest that sectors highly protected by quantitative restrictions also had the highest tariffs. Thus, raw materials and capital goods were much easier to import than finished goods, food and agricultural products.

Most non-tariff barriers were eliminated in the region and, as shown by Edwards (1995a, p. 126), the coverage of non-tariff barriers was 0 percent in Bolivia, Peru and Ecuador in 1991–92, 1 percent in Colombia and 5 percent in Venezuela. No (or very few) non-tariff barriers have been adopted by the Andean countries after 1992 according to the yearly evaluation undertaken by LAIA.9

The Andean Community

Early History
The movement toward regional integration began in Latin America during the 1950s and took concrete form with the signature by 11 countries of the Latin American Free Trade Association (LAFTA) in 1960. Integration arrangements were supposed to overcome the limits imposed by small domestic markets on an import-substitution development strategy, allowing economies of scale and providing competitiveness and a training ground for local firms (De la Torre and Kelly 1992). Important results were obtained in 1960–66 but decreased markedly after 1967 (Aitken and Lowry 1973; Wonnacott and Lutz 1989, Table 2.2, p. 76).

Many thought at the time that the lion’s share of the benefits generated by LAFTA would go to countries already relative well-off—i.e., Mexico, Brazil and Argentina—and that LAFTA was too “trade oriented”: “It did not include measures to guarantee balanced development among the countries, nor did it assure—by means of investment-planning on a regional scale—the equitable distribution of the benefits of integration” (Ffrench-Davis 1977, p. 138). Integration was the panacea, and it was thought that its benefits should go to domestic producers rather than to foreign enterprises. In such a dream it did not matter much that countries were poor, entrepreneurship lacking and economic interaction practically nonexistent; intra-regional trade represented less than 2 percent of total trade at the time.10

“Export pessimism,” the United Nations Economic Commission for Latin America and the Caribbean (ECLA), and the so called “dependency school”—which in its more extreme forms argued that trade caused underdevelopment and poverty—did not create a healthy environment to promote trade and commercial integration. Socialist President Salvador Allende in Chile and the left-leaning military government in Peru were not defenders of trade and free markets.

The Bogota Declaration in August 1966 and the Declaration of the American Presidents in April 1967 were the two central preliminary steps toward the creation of the Andean Group. The Bogotá Declaration considered the creation of subgroups with similar levels of development in LAFTA; and the Declaration of the American Presidents contemplated the possibility of speeding up subregional integration processes and of going deeper than LAFTA (Lozano and Zuluaga 1998). The issue was officially settled when LAFTA accepted Venezuela’s accession to the Andean Pact in 1973 (Guerrero 1979, p. 218). It became irrelevant in 1980 when LAFTA evolved into LAIA (Latin American Integration Association), which allowed countries to sign subregional agreements without extending concessions to other partners (Decision 44).

The Andean Group was created by the Cartagena Agreement, signed by Bolivia, Chile, Ecuador, Colombia and Peru on May 26, 1969. Venezuela joined in 1973,11 and Chile withdrew in 1976. The two principal organisms responsible for designing and implementing policies were the commission (executive body) and the junta (technical body).12 Decisions taken by the commission were adopted automatically in the countries, not requiring congressional ratification or approval. The Andean Court of Justice was created in 1979, inspired by the European institutions, though countries have been reluctant to settle disputes formally through this mechanism. It seems that only recently has it been instrumental in the area of intellectual property rights.
The policy instruments of the Andean Group were:

- a liberalization program among the member countries
- the CET
- the sectoral development programs
- a common policy toward direct foreign investment.

Both the CET and regional liberalization were supposed to be in place in 1980, 10 years after the agreement was signed (see below), but there were multiple delays, and the initial agreements were re-written in 1976 and 1978 (Lima and Arequipa Protocols), and again in 1987 (Quito's Protocol). Only in the 1990s were the two goals achieved. Regional obstacles were finally removed between 1990 and 1992, and the CET was finally signed in 1994. We explore these two issues below.

**Sectoral Development Programs.** Looking at the Andean experience, Hirschman argued that every time a new development model failed in Latin America, a more ambitious model was tried (quoted by Urrutia 1981, p. 74). Trade and integration were the central elements in the original conception pushed by Colombia and Chile, but things changed later on. Sectoral development programs, industrialization and industrial planning received much more attention during the first two decades of the agreement.

The emphasis on industrial planning and industrialization was the key to most of the problems suffered by the Andean integration scheme during almost three decades. Guerrero (1979, p. 359), for example, argues that the design and implementation of the industrial programs received almost all the attention from the organisms created in Lima, with very meager results. No country wanted to be left out of any industrial program, and the technical body of the Cartagena Agreement ended up distributing little bits of each program to all five countries (Guerrero 1979, p. 223).

The two small countries, Ecuador and Bolivia, pushed this approach with the support of Venezuela and Peru. Ecuador and Bolivia considered industrial planning the ideal tool to counterbalance their lack of new industry and to tame the undesirable effects of market forces. In the same direction, Venezuela's private sector argued that they could not compete in a situation of an "overvalued" exchange rate because of large oil exports (see Urrutia 1981; Guerrero 1979). Even worse, these countries conditioned any agreement on liberalization and trade to the industrial programs (Guerrero 1979, pp. 234; 261–63).

Besides, all products being negotiated were placed in "limbo" and could not be liberalized while negotiations continued.

During the first 10 years the technical body of the agreement presented proposals for eight industrial programs, but countries only approved those for petrochemicals and machine tools (the other programs were automobiles, fertilizers, steel, electronics, chemicals and pharmaceuticals).

A "typical" program specified the list of products (tariff items) included in the program, a very high CET, the path of regional liberalization and the list of products assigned to each country. Production of these goods rarely materialized. It was too difficult to produce some of the goods in countries like Bolivia, and the larger countries never fulfilled their commitments not to allow production of the "new" sectors in their domestic markets (Urrutia 1981, pp. 76–7).

**Foreign Investment.** The initial idea was to have a common policy in the area, but the final result was a policy designed to exclude multinationals from the benefits of the industrial programs. Decision 24 in December 1970 prohibited investment in some areas (namely, mining, public utilities and the financial sector), created strict controls on technological transfer and patents, considered limits on foreign ownership, and restricted profit remittances to 14 percent of total investment. It was adopted against the will of the private sector in all five countries (Guerrero 1979, p. 239).

For Carlos Díaz Alejandro (1976) Latin America would have done much better during the 1930s had integration schemes been in place at the time, and he argued that integration schemes were really designed for that purpose. Unfortunately, history did not pass this test, and regional agreements did even worse in periods of international crisis, when countries drastically cut all imports from their neighbors of "non-essentials." Regional trade flows were greatly reduced during the 1980s, and the Andean Group virtually collapsed (Ocampo and Esguerra 1995, p. 124).

**Open Regionalism**

The new and crucial developments of the Andean Group after 1989 were part of the same new global strategy, emphasizing free markets and trade. The crucial turning points were the presidential summits in Galapagos in
1989, in La Paz in 1990 and in Caracas and Cartagena in 1991, with important advances in the areas of trade liberalization and foreign investment, intellectual property rights and transportation.

At the Galapagos Summit the presidents agreed to eliminate administered trade and to create a free-trade zone by December 1993 (1995 for Bolivia and Ecuador) and customs union by December 1997 (1999 for those two small countries). Those dates were accelerated in La Paz to 1991 and 1995, and again in Cartagena to 1991. Bolivia was allowed to keep its flat tariff.

After four years of intense and complex negotiations, a final decision was finally adopted in 1994 (Decision 370) and a CET was in place by February 1995. "Geographic isolation" and its small size were the arguments used to allow Peru to keep the flat rate adopted in 1985/86, but Peru was not a small country with special geographical conditions. After years of negotiation and "transition periods," Peru decided to keep its flat rate and officially withdrew from the Andean Group after the presidential summit in Sucre in April 1997. Recently, there was an agreement that will allow Peru to keep its "special status" in the Andean Group until its full adoption of the Andean CET in the year 2006.

The treatment of foreign investment was drastically modified in March 1991 (Decision 291): Limits to profit remittances were eliminated, as were excluded sectors. Major changes were also undertaken in the area of intellectual property (Decisions 313 and 344), where national and most-favored-nation treatment were given, patents were protected for 20 years and "parallel imports" allowed. Most relevant, goods could be imported from the partner country when the product was registered but not used. New negotiations are currently underway in the areas of trade in services and government procurement.

Regional Liberalization

Dismantling Regional 'Exceptions' after 1990. It is not easy to present a clear picture of the liberalization process undertaken in the Andean Group after 1990 because of the many exceptions and special programs designed by different governments in the past. Just to have a rough idea of what is involved, let us consider the different categories utilized by Garay (1981, p. 108) in his analysis of regional liberalization in Colombia during the 1960s:

- Goods included in the "reserved list" (nómima de reserva);
- Products totally liberalized after February 28, 1971, not produced in the region;
- Products liberalized after April, 1970, included in the Common List in LAFTA;
- Products whose tariffs were linearly (and automatically) reduced after December 31, 1970;
- The Steel Program: (a) products not liberalized because they have not been assigned to any country; (b) products totally liberalized after September 1972, whose production was assigned to a particular country; (c) products for which liberalization began after the secretariat verified that national production started in a particular country; and
- The Petrochemical Program: (a) products included under Agreement No. 6 in LAFTA, totally liberalized by Colombia; (b) products not liberalized to a particular country because the product was not assigned to that country; (c) products totally liberalized after September 1975; (c) products liberalized linearly and automatically.

The truth is that only some few "enlightened" individuals understood what was going on—mainly bureaucrats who themselves negotiated the agreements, and rarely people from the private sector. This made it difficult to do business in the region.

Here is our best effort to describe the liberalization process adopted after 1990. 17 We must basically consider products in four categories: (a) goods included in liberalization agreements negotiated under LAFTA; (b) goods not produced in the region—and not included in the industrial programs; (c) goods produced under industrial programs; and (d) other goods.

LAFTA defined a list of products (the "Common List") to be liberalized in different subperiods and using different modalities. Products covered in the First Tranche of the Common List were liberalized in 1969 (when the agreement was signed). The rest of the Common List and those goods not produced in the region (category b) were slated to be liberalized before December 1971. This did not happen, and their status remained in limbo. 18 Goods included in category d should be fully liberalized by 1980. The original commitments were never implemented, and periods were extended in Lima (1976), Arequipa (1978) and Quito (1987).
As for the industrial programs (category c), we turn first to the Petrochemical Program, which was started in 1970 and was partially negotiated before the creation of the Andean Group under the so-called Complementarity Program in LAFTA (No. 6, which had Peru, Bolivia, Chile and Colombia as subscribers). Production rights were assigned to different countries, and the commitment was made not to promote investment in the other countries. The program was adopted in 1975, and full regional liberalization of these products was reached in May 1991 by Bolivia, Colombia, Peru and Venezuela.19

The Machine Tools Program started in August 1972, but the withdrawal of Chile and the admission of Venezuela forced new negotiations, which were finally concluded in 1979. A new agreement was reached in May 1991 to fully liberalize regional trade by the end of that year.

There was agreement on the list of products considered in the Steel and the Automobile Programs, but the pattern of regional liberalization was only agreed upon at the end of the 1980s; full liberalization took place after 1992. Colombia, Ecuador and Venezuela signed on the Automotive Agreement in 1993, fixing not only the CET and the pattern of regional liberalization, but also considering the minimum value-added content that was needed to benefit from low tariffs on inputs and parts (CKD—completely knocked down).

In summary, few of the initial agreements were implemented. Full regional liberalization was supposed to happen by 1980, but it only occurred in 1991. The agreements only included Venezuela and Colombia since Ecuador withdrew from the negotiations at the end of the 1980s and only participated in the Automotive Program. However, Ecuador rejoined the process later on and fully liberalized trade with its partners in January 1993.

The Weight of the Exceptions to Regional Liberalization. We base our calculations on the list of items included in the Automotive, the Machine Tools (Decision 300), and the Steel Programs (Decision 299); and of those included in the "Reserved List" and the "Exceptions List" (Decision 263). Together, they account for all the exceptions at the time (for a description of each list see Guerrero 1979).

Table 1 presents the relative importance of those goods excepted from the liberalization compromises by the end of the 1980s. We show results for BEC and ISIC classifications for Colombia, Ecuador and Venezuela, and for the three countries as a group.

Close to 25 percent of imports from the region in 1992 were exempted from regional liberalization, exceptions being higher in industry than in agriculture or mining, and higher in "transport equipment" (83.7 percent of imports exempted), "textiles, footwear and clothing" (60.6 percent), "consumer goods in general" (31.4 percent), and "capital goods" (53.3 percent).

Exceptions represented close to 15 percent in Colombia, and 25 percent in Ecuador and Venezuela, but the structure was relatively similar for the three countries. The Spearman rank correlation for the first classification of the table was 0.96 for Colombia-Ecuador, 0.87 for Colombia-Venezuela and 0.96 for Ecuador-Venezuela.

The Common External Tariff

The Cartagena Agreement of 1969 stated that the CET should be adopted before December 1980, with an additional period of five years for Ecuador and Bolivia. A minimum Common External Tariff was designed as an intermediate step, where tariff levels varied with such criteria as labor-intensiveness, technological sophistication, the uses of the product and the existence of domestic production. The CET was finally signed in November 1994 (Decision 370), and started being applied in February 1995. The adoption of the CET took 15 years more than initially agreed, and it is only partial, because Bolivia (permanently) and Peru (until 2006) can keep their flat tariffs.20

The Andean presidents defined the main characteristics of the CET in Galapagos in 1991: It would have four levels—5 percent, 10 percent, 15 percent and 20 percent—and the 20 percent level would disappear in one year. In practice, capital goods and raw materials not produced in the region got the lowest tariffs (5 percent), semi-processed products got tariffs of 10 to 15 percent and final consumer goods got 20 percent. Each country can adopt a low 0 to 5 percent tariff if the goods are not produced in the region, even if the tariff contained in Decision 370 is higher. Finally, Decision 370 does not include the Automobile Pact, which has a maximum tariff of 35 percent (maximum tariffs in Decision 370 are 20 percent).21

Annex 2 of Decision 370 allows Ecuador to have lower tariffs (5 points lower) for 990 items (harmonized eight digits), and Annex 3 allows zero tariffs for 32 items (goods related to health, education and massive communications).
### TABLE 1
**Exceptions to Regional Liberalization, Prior to 1990**
(Percentages)

<table>
<thead>
<tr>
<th>Imports Expected/Total Imports</th>
<th>Colombia, Ecuador and Venezuela</th>
<th>Colombia</th>
<th>Ecuador</th>
<th>Venezuela</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I. Broad Economic Categories</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Food and Beverages</td>
<td>3.2</td>
<td>4.7</td>
<td>10.7</td>
<td>0.9</td>
</tr>
<tr>
<td>2. Producers’ Materials</td>
<td>22.6</td>
<td>12.8</td>
<td>24.6</td>
<td>20.8</td>
</tr>
<tr>
<td>3. Oil and Lubricants</td>
<td>–</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>4. Capital Goods (exc. Transport Equipment)</td>
<td>53.3</td>
<td>6.7</td>
<td>57.0</td>
<td>46.9</td>
</tr>
<tr>
<td>5. Transport Equipment</td>
<td>83.7</td>
<td>93.9</td>
<td>63.4</td>
<td>64.8</td>
</tr>
<tr>
<td>6. Consumer Goods</td>
<td>31.4</td>
<td>5.6</td>
<td>13.1</td>
<td>33.9</td>
</tr>
<tr>
<td><strong>II. ISIC rev. 2</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Agricultural &amp; Livestock Production</td>
<td>0.2</td>
<td>0.2</td>
<td>0.0</td>
<td>0.2</td>
</tr>
<tr>
<td>12. Forestry</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>13. Fishing</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>21. Coal Mining</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>22. Crude Petroleum &amp; Natural Gas Production (gas only)</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>23. Iron Ore Mining</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>29. Other Minerals</td>
<td>0.2</td>
<td>0.0</td>
<td>2.8</td>
<td>0.0</td>
</tr>
<tr>
<td>31. Food, Beverages and Tobacco</td>
<td>3.4</td>
<td>4.0</td>
<td>10.7</td>
<td>1.3</td>
</tr>
<tr>
<td>32. Textiles, Footwear and Clothing</td>
<td>60.6</td>
<td>43.3</td>
<td>101.3</td>
<td>62.6</td>
</tr>
<tr>
<td>33. Wood Products</td>
<td>22.1</td>
<td>0.0</td>
<td>53.6</td>
<td>23.6</td>
</tr>
<tr>
<td>34. Paper and Printing Products</td>
<td>41.6</td>
<td>17.0</td>
<td>97.4</td>
<td>36.6</td>
</tr>
<tr>
<td>35. Chemicals</td>
<td>7.5</td>
<td>1.6</td>
<td>29.9</td>
<td>3.9</td>
</tr>
<tr>
<td>36. Non Metallic Minerals</td>
<td>23.0</td>
<td>0.9</td>
<td>57.8</td>
<td>17.0</td>
</tr>
<tr>
<td>37. Iron and Steel</td>
<td>26.7</td>
<td>39.1</td>
<td>11.5</td>
<td>3.4</td>
</tr>
<tr>
<td>38. Metal Products and Machinery</td>
<td>46.2</td>
<td>79.4</td>
<td>29.3</td>
<td>16.4</td>
</tr>
<tr>
<td>39. Other Manufacturing Industries</td>
<td>3.3</td>
<td>0.3</td>
<td>25.9</td>
<td>0.6</td>
</tr>
</tbody>
</table>

Source: Data Intal and Cartagena’s Agreement Board

**Methodology:** Imports from the Andean Region, 1992.

Exceptions Included: Metal-Mechanical Program, Steel Program, Automobile Program, “List of Exceptions” and “Reserved List”

Finally, Annex 4 permits transitory exceptions for Colombia and Venezuela (230 items each) and Ecuador (400 items). All those exceptions should disappear in 1999.

Table 2 compares the CET with the national tariffs of 1992, when most reforms had already taken place. The results show that both the CET and the tariff schedules of Colombia, Venezuela and Ecuador protect more “transport equipment,” “food and beverages” and “other consumer goods,” and protect less “oil and lubricants,” “other raw materials” and “other capital goods.” Tariff structures did differ somewhat among countries, however. The Spearman rank correlation between the tariff schedule of Colombia and the CET is 0.9 and the same figure is obtained for Ecuador. But the rank correlation for Venezuela-CET is 0.7, which suggests that Venezuela had to introduce more changes than the other two countries in order to adopt the CET.

Venezuela protects “food and beverages” relatively more than Colombia and Ecuador, and “transport equipment” relatively less. Also, and for obvious reasons, Venezuela tends to protect “oil and lubricants” less than the other two countries. Ecuador gives less protection to raw materials in general.

Did tariffs increase as a result of the adoption of the CET? We suggested before that this was the case, but changes were relatively mild for the aggregate. The detailed figures of the table show that the adoption of the CET increased protection in all subsectors; even in “transport equipment,” if we consider the correct figures (see above).

Was it convenient to adopt a CET in the Andean Group? We think so. To start with, even if tariffs increased over the levels of 1992, they were much lower (and homogeneous) than in any other decade of the past. Thus, the adoption of the CET gives the correct long-run signals to the private sector.
TABLE 2
The CET and National Tariffs
(percentages)

<table>
<thead>
<tr>
<th>U.N. BROAD ECONOMIC CATEGORIES</th>
<th>CET 1992</th>
<th>BOLIVIA</th>
<th>COLOMBIA</th>
<th>ECUADOR</th>
<th>PERU</th>
<th>VENEZUELA</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Foods and Beverages</td>
<td>15.8</td>
<td>10.0</td>
<td>14.8</td>
<td>13.5</td>
<td>17.6</td>
<td>16.1</td>
</tr>
<tr>
<td>6 Other Consumer Goods</td>
<td>17.6</td>
<td>10.0</td>
<td>15.0</td>
<td>14.5</td>
<td>20.7</td>
<td>14.4</td>
</tr>
<tr>
<td>3 Oil and Lubricants</td>
<td>9.7</td>
<td>10.0</td>
<td>9.7</td>
<td>9.2</td>
<td>15.0</td>
<td>2.2</td>
</tr>
<tr>
<td>2 Other Raw Materials</td>
<td>11.9</td>
<td>10.0</td>
<td>10.2</td>
<td>8.7</td>
<td>16.1</td>
<td>10.1</td>
</tr>
<tr>
<td>5 Transport Equipment</td>
<td>16.4</td>
<td>9.7</td>
<td>20.6</td>
<td>13.0</td>
<td>15.2</td>
<td>15.4</td>
</tr>
<tr>
<td>4 Other Capital Goods</td>
<td>11.9</td>
<td>8.8</td>
<td>9.2</td>
<td>7.2</td>
<td>15.2</td>
<td>8.4</td>
</tr>
<tr>
<td>7 Others</td>
<td>8.5</td>
<td>10.0</td>
<td>14.0</td>
<td>17.2</td>
<td>15.3</td>
<td>9.2</td>
</tr>
<tr>
<td>TOTAL</td>
<td>12.8</td>
<td>9.4</td>
<td>11.1</td>
<td>10.2</td>
<td>16.2</td>
<td>11.8</td>
</tr>
</tbody>
</table>

Source: LAIA, Carragena Agreement

Methodology: Weighted averages, total imports (5 countries, 1992) as weights; par-tariffs included. The figures of this Table are based on Decision 370 of 1994, which does not include the Automotive Pact. The average unweighted tariff for the 23 tariff items negotiated under that agreement was 26.8 percent, while the CET (Decision 370) was 18.2 percent for those same items. On the other hand, averages for the CET could be lower since countries can apply lower tariffs for goods not produced in the region.

Second, the discussion on the merits and costs of free-trade areas and custom unions seems to be shifting in favor of the latter. Thus, Wonnacott and Lutz (1989, p. 67) argued initially that a free-trade area generally dominates a customs union, but Wonnacott (1996, p. 92) has given a more balanced view recently. He mentions two main advantages of the CET: The hub and spoke problem does not arise; and rules of origin are not required. Similar conclusions are presented by Krueger (1993 and 1995).

Finally, the argument that a free-trade area would imply lower tariffs does not seem to apply to Latin America. In fact, the opposite seems to have happened, and the CET has been useful to check those pressures to increase the tariff to those levels prior to reforms. It could be true, however, that the adoption of the CET reduced the probability of the adoption of a flat tariff in some of the countries.

Reforms and Trade Flows

The Broad Picture

Figures 2 and 3 present a broad picture of the evolution of trade flows in the Andean region between 1970 and 1995. It is clear, to start with, that total imports and exports were not very dynamic. After a vigorous expansion in 1970–80, total exports and imports deteriorated abruptly during the first part of the 1980s, with sales to the Andean countries being hit especially hard. Total exports and imports in 1986 represented less than half of those reached in 1980, and they were lower in 1995 than in the previous peak of 1980. Total real exports increased very quickly between 1986 and 1990, but decreased in 1990–92 and remained stagnant in the whole period 1990–95.

What is remarkable is the expansion of manufactured exports and the stability of manufactured imports. They also fell during the first years of the 1980s, but their recovery started in 1982–84, much faster than for all the other variables considered in the figure.

Figure 3 shows that an increasing proportion of those manufactured exports went to the Andean markets after 1990. The figure also shows that the relative weight of intra-regional trade in total trade has increased rapidly since 1990 to levels similar to those in Mercosur, but it is still much lower than in NAFTA (30 percent) or in Europe (higher than 70 percent). Again, what is really remarkable is the importance of the Andean countries as markets for their own manufactured exports, with a participation higher than 30 percent in 1995. This level is much higher than in Mercosur, and similar to the one reached in NAFTA.

The role played by the Andean countries as markets for their manufactured exports was especially marked during 1990–95 when exports to the region grew five times faster than manufactured exports to the world. The boom of 1986–90 spread across all markets, but the boom of 1990–95 was concentrated in sales to the Andean markets.

Colombia and Venezuela, the largest two economies in the group, accounted for an increasing proportion of exports to the Andean region (68.1 percent in 1986; 82 percent in 1995) and for a decreasing proportion in Andean exports to the world (79 percent in 1986 and 71.4 percent in 1995).
The fall in manufactured exports during 1980-86 was common to four of the countries (except Venezuela), and the global expansion of 1986-90 was especially marked in Venezuela, Peru and Ecuador. In fact, it is not clear why Colombian exports to the region stagnated in a period in which its total manufactured exports were growing rapidly.

**Did Trade Reforms Matter? Gravity Models**

How much did trade flows increase as a result of unilateral liberalization cum regional integration? To answer the question we use the so-called gravity model, which says that trade between two countries is proportionate to the product of their GNPs and inversely related to the distance between them, by analogy to the gravitational attraction between two masses in physics. Unexplained trade is attributed to factors not included in the model such as relative prices and economic policy.

Despite some recent criticisms (Bhagwati and Panagariya 1996, p. 34) and its “dubious” theoretical heritage (Deardorff 1984), the main virtue of the model is its capacity to fit the data remarkably well. Besides, Helpman and Krugman (1998, p. 167) gave new theoretical justification to the model, arguing that the validity of the model is closely tied to the presence of increasing returns.

Equation (1) presents the gravity equation following Frankel’s formulation (Frankel 1994, pp. 11-21). Exports from country *i* to country *j* will be positively related to GNP (*Y*) and to per capita income (*Y/N*, *N* for population) in each country, and negatively related to distance. The product specification implies that trade will be larger when GNPs are similar, a feature of the new trade models under imperfect competition. It is also expected that countries trade more when *Y/N* is large, since they tend to specialize more and trade more as they develop. We include dummy variables for “adjacency,” and for three common markets, the Andean region, Mercosur and Central America.

\[
\log (X_{ij}) = \alpha + \beta_1 \log (Y_i Y_j) + \beta_2 \log (Y_i/N_i Y_j/N_j) - \beta_3 \log (\text{Distance}) + \gamma_1 \text{D}_{\text{adjacent}} + \gamma_2 \text{D}_{\text{Andean}} + \gamma_3 \text{D}_{\text{Mercosur}}
\]

The 21 countries included in the sample are the United States and those considered by Aitken and Lowry (1973) for...
FIGURE 3
Exports to Partners/Exports to World
(percentages)

I. Total Exports

II. Manufactures

Sources: Data from and author's calculations.
Methodology: Manufactures SITC 5-8
their analysis of the impact of LAFTA and the Central American Common Market during 1959–67. The period of analysis is 1986–95, and the number of observations varies between 180 in 1987 and 316 in 1995. Results are presented in Table 3. The global fit of the regressions seems to be satisfactory, with coefficients \( R^2 \) typically superior to 0.7.

As expected, the coefficients of \( Y_i Y_j \) and \( Y_i/N_j \), \( Y_j/N_i \) are positive, and the coefficient of distance negative, all of them significant at the 99 percent level; the dummy for “adjacency” is also highly significant (95 to 99 percent) and positive. The coefficient of \( Y_i Y_j \) (\( \beta_i \)) oscillates between 0.56 and 0.68, a result consistent with the range 0.53 to 0.75 obtained by Frankel for the hemisphere. This means that trade increases with size, but less than proportionally, and that the small economies are generally more open to trade. \( \beta_j \) fluctuates between 0.34 and 0.51 (for those coefficients significant at the 99 percent level), a range consistent with Frankel’s results for the period 1965–80 (though his coefficients become extremely low, 0.06 to 0.09 for 1985 and 1990). Finally, \( \beta_j \) (distance) fluctuates between -0.58 and -1.06, and for Frankel between -0.35 and -0.68.

The regression results seem to suggest that apertura cum regional integration were central factors behind the expansion of trade flows in Central America in every year after 1988, and also in the Andean Group after 1993. However, we do not find significant coefficients for the case of Mercosur (\( D_{\text{mercosur}} \)). In a sense, this result contradicts Yeats (1997), maybe because the author centers his analysis in manufactured exports, which represent less than 65 percent of Mercosur’s exports.

The results of Table 3 allow us to explore further the impact of economic policy on trade flows. It basically quantifies the additional trade flows corresponding to the dummy variables \( D_{\text{andean}} \) (\( \gamma_j \)) and \( D_{\text{america}} \) (\( \gamma_j \)) for the period 1993–95, the only years for which \( \gamma_j \) results are significant. We report the corrected coefficients in all cases. Mercosur is not included since \( \gamma_j \) is not significant.

The first three columns of Table 4 present the confidence interval for \( \gamma_j \) and \( \gamma_j \) in equation (1); the mean value coincides with the regression coefficient in Table 3. Column (4) shows the average trade flow in each region for the respective year, and Columns (5) to (8) the gross trade creation derived from the different values of \( \gamma \). Thus, \( \gamma \) is 0.78 in 1995, with a confidence interval of 0 to 1.58, which means additional trade flows of US$73 million (79.3 percent of the average trade flow for that year).

In summary, our figures indicate that unilateral liberalization cum regional preferences could have increased trade a maximum of 60 to 79 percent for the case of the Andean Group, and 94 to 95 percent for Central America. No significant impact was found for Mercosur’s regional agreement.

### Trade Creation vs. Trade Diversion

Trade creation occurs when new imports from the partner country substitute domestic production, and trade diver-

---

**TABLE 3**

<table>
<thead>
<tr>
<th>Gravity Equation Andean Countries, Central America and Mercosur</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependent Variable: Imports (current US$)</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>C</td>
</tr>
<tr>
<td>Distance</td>
</tr>
<tr>
<td>( Y_i Y_j )</td>
</tr>
<tr>
<td>( Y_i N_j )</td>
</tr>
<tr>
<td>( D_{\text{andean}} )</td>
</tr>
<tr>
<td>( D_{\text{america}} )</td>
</tr>
<tr>
<td>( D_{\text{mercosur}} )</td>
</tr>
</tbody>
</table>

| \( R^2 \)         | 0.62 | 0.67 | 0.68 | 0.73 | 0.70 | 0.66 | 0.73 | 0.73 | 0.73 | 0.73 |
| N.Obse            | 185  | 180  | 210  | 247  | 247  | 250  | 282  | 287  | 308  | 316  |

\( Y_i \): GDP countries i and j, current US $; \( N_j \): Population; \( D \): dummy variables
All variables (except the dummies) in logs; a and b represent coefficients which are significant at the 1 and 5 percent significance level, respectively; White’s heteroscedasticity corrected standard errors in all cases

Countries included: the same countries considered in Aitken and Lowry (1973) plus the United States. These are five countries in the Andean Group; five countries in Central America; four countries in Mercosur; plus Chile, Mexico, Dominican Republic, Jamaica, Panama, and Trinidad–Tobago.
We excluded records with export levels lower than US$863,000, the value of the first quartile for exports in the sample.
sion when they substitute previous—and cheaper—imports from "abroad." In the restricted scenario specified by Viner (1950) a customs union is welfare-increasing when trade creation dominates trade diversion, but this is not necessarily true under different assumptions. Pure trade diversion can be beneficial, thanks to the effects of lower prices on consumers; trade creation can be detrimental to welfare once we consider its effects on tariff revenues. That is why Winters (1997, p. 9) considers that the measurement of these effects should be indicative rather than definitive.

Of course, the complete evaluation of the impact of trade flows on welfare should also include output and scale effects, important when there are increasing returns to scale and imperfect competition. The output effect arises when there is a change of output in industries where price differs from average cost, and the scale effect measures the reduction of average costs when output expands. We should also include variety and accumulation effects (Baldwin and Venables 1995, pp. 1600-02). Terms of trade effects should also be included, but they do not seem to be relevant in our case.

Table 5 quantifies trade creation and diversion in Colombia and Venezuela (which represent close to 70 percent of the Andean trade flows) for 1986, 1990 and 1995, measuring the relation between imports from "abroad" (non-Andean countries) and apparent consumption. We only have information on manufactures, the sector where most trade diversion could have taken place (see Figure 3 above).

Our results suggest that trade creation was much more important than trade diversion, with an increasing ratio in Colombia from 18.4 percent in 1986 to 19.3 percent in 1990 and to 23.5 percent in 1995; and also in Venezuela (23.2 percent, 25.6 percent and 29.4 percent, respectively). Trade creation seems to dominate trade diversion in most cases. The relation between imports and apparent consumption increased in Colombia in all sectors, both in 1986-95 and in 1990-95. Trade creation also dominates in Venezuela, though important amounts of trade diversion took place in "Metal Products and Machinery" both in 1986-95 and, even more, in 1990-95; in "Non-Metallic Minerals" in 1990-95; and in "Food, Beverages and Tobacco" in 1990-95. If we look at the percent change in the ratio, we conclude that trade creation was especially marked in "Textiles, Footwear and Clothing" and in "Wood Products" in Colombia and Venezuela; and in "Iron and Steel" in Venezuela. The first two sectors were very closed in both countries before liberalization, and they remained relatively closed after liberalization.

**Liberalization or Regional Preferences?**

Both unilateral liberalization and regional preferences could have been responsible for rapid export growth to the

---

### Table 4

**Gravity Equation. Derived Trade Flows**

<table>
<thead>
<tr>
<th>CONFIDENCE INTERVAL FOR $\gamma$</th>
<th>AVERAGE IMPORTS</th>
<th>CONFIDENCE INTERVAL</th>
<th>GROSS TRADE CREATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>CONFIDENCE INTERVAL FOR $\gamma$</td>
<td>MIN</td>
<td>MEAN</td>
<td>MAX</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>-----</td>
<td>------</td>
<td>-----</td>
</tr>
<tr>
<td>Dummy Andean Group</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>93</td>
<td>(0.00)</td>
<td>0.47</td>
<td>0.94</td>
</tr>
<tr>
<td>94</td>
<td>0.00</td>
<td>0.67</td>
<td>1.36</td>
</tr>
<tr>
<td>95</td>
<td>(0.00)</td>
<td>0.78</td>
<td>1.58</td>
</tr>
<tr>
<td>Dummy Central America</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>93</td>
<td>(0.00)</td>
<td>1.44</td>
<td>2.89</td>
</tr>
<tr>
<td>94</td>
<td>(0.00)</td>
<td>1.62</td>
<td>3.25</td>
</tr>
<tr>
<td>95</td>
<td>0.00</td>
<td>1.54</td>
<td>3.09</td>
</tr>
</tbody>
</table>

*Sources and Methodology:* see Table 3

Confidence Interval: $\gamma \pm t_{n-1}S(\gamma)$, with $t$ student coefficient; $S(\gamma)$: standard error of $\gamma$
TABLE 5
Trade Creation—Trade Diversion in the Andean Region

(imports from “abroad” (non-Andean countries)/apparent consumption)

<table>
<thead>
<tr>
<th>ISIC REV.2</th>
<th>COLOMBIA</th>
<th>VENEZUELA</th>
</tr>
</thead>
<tbody>
<tr>
<td>31 Food, Beverages and Tobacco</td>
<td>1.6</td>
<td>1.5</td>
</tr>
<tr>
<td>32 Textiles, Footwear and Clothing</td>
<td>2.9</td>
<td>3.6</td>
</tr>
<tr>
<td>33 Wood Products</td>
<td>2.0</td>
<td>1.8</td>
</tr>
<tr>
<td>34 Paper and Printing Products</td>
<td>12.1</td>
<td>12.3</td>
</tr>
<tr>
<td>35 Chemicals</td>
<td>23.2</td>
<td>24.4</td>
</tr>
<tr>
<td>36 Non-Metallic Minerals</td>
<td>3.8</td>
<td>3.8</td>
</tr>
<tr>
<td>37 Iron and Steel</td>
<td>31.4</td>
<td>35.4</td>
</tr>
<tr>
<td>38 Metal Products and Machinery</td>
<td>43.6</td>
<td>40.6</td>
</tr>
<tr>
<td>39 Other Manufacturing Industries</td>
<td>14.4</td>
<td>30.3</td>
</tr>
<tr>
<td>TOTAL</td>
<td>18.4</td>
<td>19.3</td>
</tr>
</tbody>
</table>

Sources: UNIDO, Yearbook of Industrial Statistics; Data Intal and author’s calculations

region, but the implications of each alternative differ radically. The first one implies a healthy expansion of exports, caused by liberalization along a “natural” pattern, while the second could be due to artificially created trade diversion, although not necessarily.

It is clear that regional preferences decreased in Venezuela during the period, from levels of 14.2 percent for agriculture in 1988 to 12.1 percent in 1994; from 12.4 percent for mining in 1988 to 3.7 percent in 1994; and from 21.3 percent to 13 percent in the same period. Preferences fell in most ISIC two-digit sectors, except in “Fishing” (ISIC 13, which increased from 7.5 percent to 15 percent) and in “Other Manufacturing Industries” (ISIC 39, from 12.7 percent to 18 percent).

Table 6 specifies import functions for manufactures in Venezuela using a pool of cross-section (ISIC three digits) and time series (1990 and 1995) data. Those were the group of products and the period for which regional reorientation was largest (see Figure 3). As dependent variables we use imports (in current U.S. dollars) from the partner country (columns (1) to (2)) and the share of the partner’s imports on total imports (columns (3) to (4)). As independent variables we consider the real exchange rate (real national currency per real U.S. dollar, negative sign expected), apparent consumption (positive sign expected), and the effect of tariffs on relative prices, \((1 + t^e)/(1 + t_{int})\); \(t^e\) corresponds to the import weighted external tariff and \(t_{int}\) to the “regional tariff.” The sign of \((1 + t^e)/(1 + t_{int})\) is not clear a priori, and depends on how important was unilateral liberalization (-) or regional preferences (+) in the explanation of import growth.

The number of observations is 48, and the adjusted coefficient of determination \((R^2 \text{ adj})\) is relatively satisfactory for a cross section—time series pool: higher than 0.6 for absolute imports, and close to 0.3 for shares. Both apparent consumption and the real exchange rate appear with the correct sign and are significant at the 99 percent level in all cases. Import elasticities relative to apparent consumption are close to 0.6, and the elasticity imports–real exchange rate between 4.81 and 5.52.

The sign of \((1 + t^e)/(1 + t_{int})\) results negative in all cases, both for nominal imports and for shares, which suggests
TRADE TOWARDS OPEN REGIONALISM

that tariff reductions, and not preferences, were the central factor behind the large dynamism showed by trade in 1990–95.

Equations (2), (4), (6) and (8) consider separately \((1 + t')\) and \((1 + \tau_{\text{intra}})\). The first variable appears with the correct negative sign in all cases, though it only appears significant for the absolute levels (both in Colombia and in Venezuela); \((1 - \tau_{\text{intra}})\) appears with the wrong sign, and it is significant for Colombia.

**Characteristics of Andean Trade:**

**Intra-Industry Trade, Factor Intensity and Comparative Advantage**

**Intra-Industry Trade**

Most world trade is intra-industry today, and takes place between rich countries with similar levels of development (Helpman 1987). Thus, Havrylyshyn and Civan (1985, p. 259) found that 58.9 percent of total trade among industrialized countries in 1978 was intra-industry (Grubel-Lloyd index of 0.589; the index takes the value of 1 when all trade is intra-industry, and 0 when all trade is inter-industry) with a much lower figure for trade among the NICs (42 percent), and even lower among the developing countries (22.6 percent).

Intra-industry trade is also intense when barriers to trade are low. Thus, it is directly correlated with distance and transport cost, and it is higher when countries form customs unions. (Loertscher and Wolter 1980). Intra-industry trade in Argentina, Brazil and Mexico is higher than in other NICs, something that some authors attribute to the existence of integration schemes in the region (Havrylyshyn and Civan 1985, p. 262).

The relative weight of intra-industry trade increased in the world during the 1960s and 1970s, but it remained stagnant during the 1980s (Globerman 1990). In Latin America it has increased decade after decade, even during the 1980s (Baumann 1992).

Table 7 presents the Grubel-Lloyd weighted index for the United States and for the Andean region (Peru excluded) between 1990 and 1995, both for total exports (without mining) and for manufactures. It shows that intra-industry trade continued rising during the 1990s: The index increased from 0.61 to 0.65 for trade between the United States and Europe, and from 0.69 to 0.73 for the United States and NAFTA. Figures are very similar for manufactures and for total exports excluding mining.

Intra-industry trade also rose in the Andean Group, from levels close to 0.35 to 0.41 (though it fell somewhat between 1992 and 1994) and it is higher for intra-Andean

**TABLE 7**

**Intra-Industry Trade (IIT) in the Region and in the United States, 1990–95**

<table>
<thead>
<tr>
<th>ANDean Countries Exports and Imports To/From</th>
<th>U.S. Exports and Imports To/From</th>
</tr>
</thead>
<tbody>
<tr>
<td>ANDean Countries</td>
<td>Mercosur</td>
</tr>
<tr>
<td>I. TOTAL EXPORTS (MINING EXCLUDED)</td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>0.35</td>
</tr>
<tr>
<td>1991</td>
<td>0.32</td>
</tr>
<tr>
<td>1992</td>
<td>0.39</td>
</tr>
<tr>
<td>1993</td>
<td>0.36</td>
</tr>
<tr>
<td>1994</td>
<td>0.35</td>
</tr>
<tr>
<td>1995</td>
<td>0.41</td>
</tr>
</tbody>
</table>

II. MANUFACTURES

| 1990 | 0.32 | 0.19 | 0.13 | 0.15 | 0.09 | 0.24 | 0.16 | 0.63 | 0.73 | 0.32 |
| 1991 | 0.31 | 0.18 | 0.15 | 0.13 | 0.08 | 0.26 | 0.17 | 0.65 | 0.73 | 0.34 |
| 1992 | 0.37 | 0.20 | 0.14 | 0.10 | 0.05 | 0.25 | 0.16 | 0.67 | 0.73 | 0.38 |
| 1993 | 0.34 | 0.16 | 0.13 | 0.09 | 0.05 | 0.23 | 0.17 | 0.66 | 0.73 | 0.36 |
| 1994 | 0.34 | 0.16 | 0.16 | 0.10 | 0.06 | 0.26 | 0.21 | 0.66 | 0.73 | 0.34 |
| 1995 | 0.39 | 0.20 | 0.13 | 0.13 | 0.05 | 0.30 | 0.20 | 0.68 | 0.76 | 0.35 |

Source: Data-Intal and author's calculations

Methodology: IIT: Andean Group. The Grubel and Lloyd weighted Index was calculated for Bolivia, Colombia, Ecuador and Venezuela, we then weighted the different countries using exports to the Andean Group as weights.

Mining: Sector ISIC 2 (rev 2); Manufacturing: ISIC 3 (rev 2)
trade than for trade with Mercosur and NAFTA, and even more than for trade with Europe and Asia.\textsuperscript{30}

It occurs in sectors where scale economies and product differentiation are important. Investment goods have a much higher intra-industry trade index (39.8 percent) than intermediate goods (31 percent) or consumption goods, though the highest IIT coefficients occur in chemicals, machinery and transport equipment (Havrlyshyn and Civan 1985, pp. 264–65; see also Ethier 1982 and Krugman 1994, p. 231).

This was also our case, the highest level of IIT being in industrial raw materials both for trade with the subregion (IIT index of 0.79) and with the world (0.66). But other sectors ("Foods and Beverages") also show high levels of IIT in the Andean region. Finally, IIT is high for "Other Capital Goods" in the Andean trade among partners, but not in trade with the world.

**Reorientation, Intra-Industry Trade, Factor Intensity and Comparative Advantage**

In this part we closely follow Yeats's analysis for Mercosur and provide further insights into the characteristics of the trade flows in the region. As in the case with the author, we are interested in insights "concerning the extent to which a regional arrangement diverts trade from patterns expected on the basis of efficiency conditions and comparative advantage" (Yeats 1997, p. 1).

Yeats combines the Regional Orientation (ROR) Index with indexes of Revealed Comparative Advantage (RCA) and factor intensity to characterize those sectors where intra-regional trade was most dynamic. He concludes that there is no evidence that Mercosur's intra-regional trade is evolving along lines consistent with efficiency conditions. Rather, "the products recording the largest shift toward the region are those for which Mercosur has not demonstrated an ability to export competitively elsewhere" (Yeats 1997, p. 17).

Table 8 divides the sample of sectors (ISIC, 3 digits) into four groups, according to export growth to the subregion (Table A-2 in the appendix presents the sectors included in each group).\textsuperscript{31} The variables considered are the Regional Orientation Index, Grubel's Intra-Industry Trade Index (both for exports to the Andes, and for exports to the world), and a Revealed Comparative Advantage Index. It also presents some standard proxies for capital intensity: value added per worker, capital stock per worker, and the participation of wages in value added.

The definition of the index comes in the notes to Table 8, and here we just mention that the ROR gets high values when products sold to the region are not sold to other markets. On the other hand, the RCA takes high values for those products exported by the Andean countries and not by the world.

Among the SITC (three digits) sectors with the most dynamic exports to the region (category 1, "very high" in the table) were some mineral products (coal mining and petroleum), but also sawmills, metal industries and machinery (electric and non-electric). Among the group with "high" export growth were agricultural products and food, some chemicals and petroleum refineries, iron and steel industries, and metallic products (see Table A-2 in the appendix).

The results in column (1) indicate that the regional market played a crucial role in the expansion of exports, since there was a close link between export dynamism and geographical reorientation. Those with the highest export growth have a ROR index of 9.11, and those with the lowest growth have a ROR index of 4.37.

There is a positive relation between intra-industry trade and export growth to the region, though intra-industry trade is also very important in group 3 ("low," 0.55). Interestingly, there seems to be a negative relation between both variables when exports go to "other" markets; the index is 0.30 for group 1 ("very fast") and 0.4 or higher for groups 2 to 4.

The dynamic sectors were not in the top list of revealed comparative advantage, something that should not worry us too much, because they are in second place, with an average index much higher than for categories "high growth" and "very low growth." This pattern is consistent for the years 1990 and 1995. The most dynamic sectors are in an intermediate position considering capital intensity, though the picture is not neat: They are in a low ranking (third place in the four groups) for value added per worker, in second place for the other two variables.

In summary, it is clear that the dynamic sectors (high export growth to the Andean region) were dynamic partly because they reoriented their exports to the Andean group and, as expected, intra-industry trade was generally higher in the dynamic sectors. However, the products exported to the region are not very capital-intensive and show some degree of comparative advantage. In some sense, then, the findings of this section confirm the central conclusion of
TABLE 8

Main Characteristics of the Dynamic Sectors
(arithmetic averages)

<table>
<thead>
<tr>
<th>EXPORT GROWTH TO THE REGION. 1990-95</th>
<th>REGIONAL ORIENTATION INDEX (ROR)</th>
<th>IIT: X AND M TO THE REGION</th>
<th>IIT: TOTAL X AND M</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(1)</td>
<td>(2)</td>
<td>(3)</td>
</tr>
<tr>
<td>1. Very High</td>
<td>9.11</td>
<td>0.53</td>
<td>0.30</td>
</tr>
<tr>
<td>2. High</td>
<td>5.05</td>
<td>0.39</td>
<td>0.40</td>
</tr>
<tr>
<td>3. Low</td>
<td>4.10</td>
<td>0.55</td>
<td>0.43</td>
</tr>
<tr>
<td>4. Very Low</td>
<td>4.37</td>
<td>0.42</td>
<td>0.42</td>
</tr>
</tbody>
</table>

REVEALED COMPARATIVE ADVANTAGE (RCA) CAPITAL INTENSITY

<table>
<thead>
<tr>
<th></th>
<th>(4)</th>
<th>(5)</th>
<th>(6)</th>
<th>(7)</th>
<th>(8)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Very High</td>
<td>8.61</td>
<td>4.20</td>
<td>75.6</td>
<td>113.8</td>
<td>35.3</td>
</tr>
<tr>
<td>2. High</td>
<td>2.65</td>
<td>1.76</td>
<td>195.4</td>
<td>125.9</td>
<td>28.1</td>
</tr>
<tr>
<td>3. Low</td>
<td>14.47</td>
<td>40.13</td>
<td>46.3</td>
<td>68.4</td>
<td>42.7</td>
</tr>
<tr>
<td>4. Very Low</td>
<td>1.07</td>
<td>1.96</td>
<td>82.7</td>
<td>91.8</td>
<td>29.9</td>
</tr>
</tbody>
</table>

IIT: Intra-Industry Trade Index; VA: value added; K: capital stock; L: employment.

Sources: Data Interns and authors calculations; Banco Central de Venezuela and Statistical Office, Colombia; U.N. Yearbook of Industrial Statistics; GTAP Database.

Methodology: ISIC (3 digit) sectors with "low" values (less than the first quartile) of exports to the Andean markets excluded; "very high," "high," etc. correspond to quartile values for export growth to the region in 1990-95.

ROR = \( \frac{S_{i,A}}{S_{i,M}} \) the share of good i in exports to the Andean markets/share of good i in exports to other markets.

IIT: Intra-Industry Trade, Grubel and Lloyd weighted index.

\[ II_T^i = 1 - \frac{\sum |X_i - M_i|}{\sum |X_i + M_i|} \]

RCA = \( \frac{S_{i,A}}{S_{i,world}} \) (share of good i (ISIC, 3 digits) in total exports made by the Andean countries/share of good i in total exports made by the world). USA's exports used as proxy for world's exports.

Capital Intensity: average for the four groups = 100. L was calculated as the sum of operatives and employees, adjusting for differences in average wages; K: capital stocks. The information for most sectors was obtained from the U.N. Yearbook of Industrial Statistics, but we also used the input/output matrix of Venezuela (1986) and Colombia (1992).

Conclusions

A very dynamic and healthy picture emerges from the experience of "open regionalism" in the Andean countries in the period 1986–95, and it is paradoxical that some political obstacles still remain when the agreement is finally working.

The Common External Tariff was adopted in 1995, not as bad a decision as some seem to suggest. The tariff structure was not modified substantially, and the absolute level is one of the lowest reached in the region ever. Those who attack the CET because they think that more liberalization is in order do not know about the political economy of protection in Latin America. In fact, there is no doubt that the
adoption of the CET has already influenced the governments of Colombia and Venezuela in the right direction.

The adoption of the CET provides long-term signals to a private sector looking for stability, and the alternative—namely, the rules of origin signed in NAFTA or negotiated by Mexico with Costa Rica, Colombia and Venezuela—are perceived as being more difficult to implement than a CET. The new literature comparing costs and benefits for free-trade areas and customs unions is not so clearly in favor of free-trade areas. One factor in this analysis is that tariffs have dropped quickly in most Latin American countries and are unlikely to be further lowered in the medium term. The CET levels in the Andean Group and in Mercosur are most likely reflect the tariff levels that will remain in place over the medium term.

We show in the paper that reforms had an important influence on trade flows, and that unilateral liberalization (and not regional preferences) was the central force behind the very high dynamism shown by total and manufactured exports to the region. The paper also shows that trade creation amply dominated trade diversion, though further research is obviously needed to determine the relation between the new trade flows and economic welfare.

Intra-industry trade between the Andean countries rose to 40 percent in 1995, a figure much higher than for exports to other regions and countries. Finally, we show that geographical reorientation was an important factor behind export growth to the region, and that the most dynamic sectors are not very far from the average in terms of capital intensity or revealed comparative advantage. These findings are entirely consistent with the fact that many firms learn to export in the regional markets and compete later in the more challenging international markets.

We know that scale economies and market segmentation are crucial factors behind intra-industry trade, and we also know that its distributional impact is much lower than for traditional trade. That explains why producers are so satisfied with the Andean Group (Echavarría 1997). But is not a protected market any more, and it is no coincidence that the averages obtained for the CET coincide with the levels recommended by Balassa (1973) more than 20 years ago.

A final comment could nicely close our discussion on integration in the region. It is paradoxical that governments are achieving industrialization through integration, the main objective sought in the old schemes—but through much more dynamic and competitive paths. This reason alone plainly justifies the recent Chilean debate on the merits of integration-industrialization in a very open economy. Indeed, trade liberalization may prove to be the successful path to the long-standing goal of competitive industrialization in Latin America.

References


Notes

1. This is a standard proposition in the Hecksher-Ohlin theory of trade, but is also valid for models with imperfect competition. In this case "world real income will definitely increase with trade, as will the real income of the smaller country. The monopolist in the large country may however reduce production relative to autarky, which could possible result in negative gains from trade for the large country" (Markusen 1993, p. 70).
1. The relation between total trade and GDP fell from 31 percent to 25 percent in the same period.

2. Haggard (1995) also mentions the pressures by the industrial countries through retaliatory commercial policies; and the changes in the regime governing international trade.

3. We assign that year to Ecuador (based on our observation of tariff reforms in the section on unilateral liberalization), though Edwards classifies Ecuador as a non-reformer.

4. Decision 370 allows countries to apply lower tariffs when the goods are not produced in the region.

5. These levels were already low compared with previous decades. Thus, Balassa (1973, p. 177) reports the following unweighted tariff levels for 1975: Bolivia (54 percent), Chile (172 percent), Colombia (70 percent), Ecuador (106 percent) and Peru (90 percent).

6. Tariffs were reduced in 10 years in Brazil, Paraguay and Uruguay. Argentina’s tariffs were reduced drastically between 1986 and 1988, but increased somewhat in 1994.

7. Tariffs and para-tariffs.

8. Raijapmcano (1998) argues that new quotas (“absorption contracts”) have been introduced recently in Colombia for agricultural imports.

9. To be sure, these goals were shared by other integration agreements such as the Central American Common Market. However, while regional trade represented 10 percent of GDP in Central America, it only represented 1 to 2 percent of GDP in the Andes and in the LAFTA countries (Wonnacott and Lutz 1989, p. 76).

10. Venezuela participated in the negotiations but did not sign the agreement in 1969, mainly because the private sector was opposed to it.

11. There is also the Consultive Committee, created to promote communication between the countries and the Junta; and the Advisory Committee on Social Issues (Comité Asesor Económico Social) composed of workers and the private sector.

12. The Lima Protocol asks for a process of regional liberalization for 1979–84; and the Arequipa Protocol changed the period to 1980–84. The Quito Protocol demanded that regional liberalization should be reached by 1997.

13. The Lima Protocol asks for a process of regional liberalization for 1979–84; and the Arequipa Protocol changed the period to 1980–84. The Quito Protocol demanded that regional liberalization should be reached by 1997.

14. Urrutia (1981), p. 78, for example, mentions that the CET negotiated for the metal-mechanical program was 51 percent, compared with a Colombian tariff of 29 percent for the same products. The average external tariff agreed for automotive parts was 49 percent, compared with 19 percent for the Colombian tariff.

15. Local participation had to be higher than 50 percent for new foreign investment (except if the firm exported more than 80 percent of total production) and for firms exporting to the Andean region with low tariffs.

16. The first part of this section is based on Urrutia (1981) and Lozano and Zuluaga (1998).


19. The Petrochemical Program assigned 55 products to one country and 15 to two countries; two additional products could be produced in the other two countries. But the program failed. Bolivia produced two out of the 10 “products” assigned and failed in both cases when Venezuela violated the original agreement and started producing them. See Urrutia (1981), p. 76.

20. Bolivia’s tariff had two levels of 10 percent and 19 percent in 1988, and 3 percent and 10 percent in 1994. The Peruvian tariff had two levels: 15 percent and 25 percent in 1994.

21. The average unweighted tariff for the 22 tariff items negotiated under the “Automotive Agreement” was 26.8 percent, while the CET’s (Decision 370) was 18.2 percent.

22. With trade diversion occurring, and Partner A buying from Partner B a product previously bought “abroad,” Partner A can decrease the costs in an FTA with lower tariffs. This “unilateral decision” is not possible in a customs union.

23. NAFTA lost participation in our exports of manufactures but gained participation in exports of non-manufactured goods. The participation of the EEC and Asia decreased for almost every type of product.

24. We also tried, unsuccessfully, to include relative prices and exchange rates. It would be interesting to see whether our results would change if we excluded oil imports from the calculations. Frankel (1994, pp. 20–1) tried some additional variables but the results were not affected. He found only a “bit” of support for Heckscher-Ohlin type variables: differences in capital/labor ratios, educational attainment levels and land/labor ratios.

25. Five countries in the Andean Region, four countries in Mercosur, five countries in the Central American Common Market, two NAFTA countries (Mexico and the United States), plus Chile, Jamaica, Panama, the Dominican Republic and Trinidad-Tobago.

26. This is the methodology followed by Resnik and Truman (1973) and suggested by Winters (1997, p. 12). The ratio is a proxy for the relation between imports and GNP, assuming that $X=M_i + M_o$, where $X$ corresponds to exports, and $M_i$ and $M_o$ to imports from partners and from non-members. See Winters 1997, p. 12.

27. $T_{int}$ is either 0 (fully liberalized) or $t^*$ (excepted) for each harmonized item, eight digits. However, it can take any value once we get weighted averages.

28. See Grubel and Lloyd (1975). The index is built as $\frac{\sum |X_i - M_i|}{\sum (X_i + M_i)}$ where $i$ is normally the 3-digit industrial classification (ISIC). It is expected that $i$ is a homogeneous sector, with similar capital-labor ratios for the different subsectors.

29. Our original data is at the level ISIC 4 digits. We then build the Grubel and Lloyd index.

30. There are some common features, but also important differences among the five countries: IIT is higher for trade with the Andean partners in Colombia and Venezuela and today also in Ecuador (not in 1990 or 1991, when Ecuador showed the fastest growth in IIT). On the other hand, Peru is the only country for which IIT with the Andean region has decreased through time. Finally, IIT levels are very low for Bolivia, even lower than for Bolivia’s trade with Mercosur. This suggests, again, that distance is a key variable in the explanation of trade flows in the region.
31. Following Yeats, we excluded from the analysis those sectors with very low exports to the Andean markets in 1990 (i.e., we exclude the lowest quartile) to prevent the results being biased by marginal products. This reduced our sample from 41 ISIC three-digit sectors to 31 sectors. We divide the sample into four groups according to quartiles for export growth.
### Table A.1

<table>
<thead>
<tr>
<th>Levels</th>
<th>Andean Countries, 1989-95</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>WEIGHTED IMPORTS AVERAGES</td>
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<tr>
<td></td>
<td>ANDIAN COLO-</td>
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<td></td>
<td>BOLIVIA</td>
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<td></td>
<td>A. Total Border Taxes (Tariffs and Para-Tariffs)</td>
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<tr>
<td></td>
<td>86</td>
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<td></td>
<td>88</td>
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<td>B. Tariffs</td>
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<td></td>
<td>94</td>
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<tr>
<td></td>
<td>95</td>
</tr>
</tbody>
</table>

### Para-Tariffs:

- **Bolivia**: Tasas por Servicios Prestados
- **Colombia**: Impuesto Adicional (Art. 9 Ley 50/84) mainly
- **Ecuador**: Recargo Arancelario
- **Peru**: Sobretasa

### Methodology:

- Imports of 1993 (in each country) used as weights; figures for Colombia, Ecuador and Venezuela correspond to the Common External Tariff (Decision 370).
## Dynamic and Not-So-Dynamic Sectors

### (exports to the subregion)

<table>
<thead>
<tr>
<th>GROUP 1. VERY HIGH EXPORT GROWTH</th>
<th>GROUP 3. LOW EXPORT GROWTH</th>
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</thead>
<tbody>
<tr>
<td>210 Coal mining</td>
<td>321 Textiles</td>
</tr>
<tr>
<td>220 Crude petroleum &amp; natural gas production (gas only)</td>
<td>322 Manufacture of wearing apparel, except footwear</td>
</tr>
<tr>
<td>290 Other minerals</td>
<td>352 Other chemical products</td>
</tr>
<tr>
<td>331 Sawmills, planing &amp; other wood mills</td>
<td>356 Plastic products</td>
</tr>
<tr>
<td>354 Manuf. of miscellaneous products of petroleum and coal</td>
<td>361 Manufacture of pottery, china and earthenware</td>
</tr>
<tr>
<td>372 Non-ferrous metal basic industries</td>
<td>390 Other manufacturing industries</td>
</tr>
<tr>
<td>382 Non-electric machinery</td>
<td></td>
</tr>
<tr>
<td>383 Electric machinery</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>GROUP 2. HIGH EXPORT GROWTH</th>
<th>GROUP 4. VERY LOW EXPORT GROWTH</th>
</tr>
</thead>
<tbody>
<tr>
<td>111 Agricultural &amp; livestock production</td>
<td>312 Food products exc. beverages</td>
</tr>
<tr>
<td>311 Food products exc. beverages</td>
<td>313 Beverages</td>
</tr>
<tr>
<td>342 Printing, publishing &amp; allied industries</td>
<td>323 Tanneries &amp; leather finishing</td>
</tr>
<tr>
<td>351 Manufacture of basic industrial chemicals except fertilizers</td>
<td>341 Manufacture of pulp, paper &amp; paperboard</td>
</tr>
<tr>
<td>353 Petroleum refineries</td>
<td>355 Rubber products</td>
</tr>
<tr>
<td>371 Iron and steel basic industries</td>
<td>362 Manufacture of glass and glass products</td>
</tr>
<tr>
<td>381 Metallic products exc. machinery</td>
<td>369 Non-metalic minerals</td>
</tr>
<tr>
<td>385 Manufacture of professional and scientific, and measuring and controlling equipment, n.e.c.</td>
<td>384 Transport equipment</td>
</tr>
</tbody>
</table>

**TABLE A-2**

**TRADE: TOWARDS OPEN REGIONALISM**
Comment

SARATH RAJAPATIRANA

Juan José has written an interesting and informative paper. What is new in the paper is the focus on trade flows using a variety of measures to find out what has happened to them in the last decade. His principal finding is that the manufactures trade among the Andean Group countries has increased rapidly compared with the trade with the non-member countries. In addition, he finds that the most rapid growth was in intra-industry trade. What is, however, most interesting is that he finds the reason for the increase in manufactures trade was unilateral trade liberalization among the members of the group rather than the exchange of preferences. His main evidence is the reduction in tariff preferences at the time the rapid growth in trade was taking place in response to the liberalization of the trade regimes, particularly in Bolivia, Colombia and Peru and, to some lesser extent, Venezuela—and, to an even lesser extent, Ecuador.

In the paper Juan José draws a sharp contrast between the Andean Group of the 1960s and the one that was reborn in the late 1980s. As the Vice Minister for Trade at the time when Colombia liberalized its trade regime rapidly, Juan José is eminently placed to speak to the issue of the contrast in approach and intent for the new Andean Group. There are interesting observations in the paper about the negotiations related to the adoption of a Common External Tariff (CET) that reveal the different interests of the member countries. It is also interesting to note that the CET that emerged showed the closest affinity to the Colombian and Ecuadorian tariff structures than to those of Bolivia and Peru. The latter two countries have lower and more uniform tariffs. Peru, as we know, opted to leave the Andean Group and, more recently, to rejoin the Group. Bolivia was permitted to keep to its two 5 percent and 10 percent tariffs, which conform to the lower two rates of the CET.

I raise a number of issues for discussion on the paper. I note that Juan José’s paper attempts to meet the ideal described in Alan Winters’s survey for this conference that the purpose of the conference is to consider ways of thinking about regional integration agreements rather than to give definite answers. It is in this spirit that I raise these issues.

Trade Flows and Welfare
Measuring trade flows does not answer the welfare question—whether the Andean Group members are better off with the Andean Group or with unilateral liberalization, either as a group or in terms of individual countries. While the paper does not claim that it is attempting to answer what it calls this “classic question,” it is important to bear in mind that trade flows in general and export growth in particular cannot answer questions of welfare. The paper does not cast the inquiry in terms of the Vinerian concepts of trade creation and trade diversion. In fact, part of the increase in trade can well be trade diversion rather than trade creation. Even so, it is important to note that the evidence shown in the paper supports the view that unilateral

Sarath Rajapatirana is an Adviser to the Operational Services Team of the World Bank.
trade liberalization is the main factor in the rapid growth of manufactures exports. This reduces the possibility of trade diversion. That unilateral trade liberalization leads to more intra-regional trade has been observed in the case of the ASEAN countries, which had exchanged weak preferences with each other.

**Measures of Trade Flows**

My second comment relates to the different measures used in the paper such as the Intra-industry Trade Index (the Grubel weighted index), the Trade Orientation Index (used by Yeats), and the Revealed Comparative Advantage Index of Bela Balassa. All these measures are static measures in the sense they take the past pattern of trade as given. While they are convenient starting points to pose questions regarding the effects of different trading arrangements on trade flows, they are not measures on which policy issues can be analyzed. The main problem with them is that they provide little guidance to the proper counterfactual for analysis. For example, if a country has liberalized its trade, we cannot expect trade flows to be predicted by these indexes with a reasonable degree of accuracy. We would be forcing a counterfactual of a given history that, in most cases, may not be the appropriate counterfactual. This is because the indexes by and large reflect past trade policies and all the other factors that impinge on trade flows of the past. Particularly at a time when patterns of demand and consumption, access to inputs and access to new markets are changing rapidly, the indexes may well be understating the potential for the expansion of trade. New export avenues and opportunities arise in unpredictable ways when countries open up. That has been the common experience. They are hardly ever captured by indexes of this type. At best, these indexes indicate potential; but that potential could be larger than what the indexes indicate.

**Trade Policies vs. Other Determinants of Trade Flows**

Third, it is important to note that trade flows are affected by many factors—namely, exchange rates, global economic conditions, terms of trade, foreign investment, and other variables such as transport costs. Trade flows are themselves determined by factors that are outside of trade. To the extent these factors are present at the time of unilateral trade liberalizations and in the exchange of preferences, they have to be taken into account. It is easy to see that the export and import demand functions have many right-hand-side variables that go beyond trade. So one can imagine the difficulties in predicting trade flows from past relationships.

**Remaining Agenda for Trade Reform in the Andean Group**

Fourth, despite the strong trade reforms undertaken in the last decade and the reduction of trade barriers within the region, there is an important unfinished agenda for reform in the Andean Group. Achieving this agenda will enable the realization of more gains. I highlight five elements of that agenda:

(a) Agriculture protection has continued in the form of the agriculture price band system. This provides protection to agriculture, although the system has been justified on the basis of stabilizing agricultural prices. The long five-year memory of the prices carried in the system makes price bands unresponsive to secular price declines.

(b) The automobile sector continues to remain protected above the CET rate. There is little justification to continue with it. Also, overall protection levels can be reduced further: The four rates can be reduced to two rates as in Bolivia, or a uniform tariff like the CET can be adopted, which Peru has been contemplating.

(c) Although the Andean Group is a customs union with a CET, there are rules of origin that act as protective device. Until all the exemptions from the CET are rescinded, this type of trade impediment will continue. Given that Andean Group members have individually signed different bilateral agreements, they have different rules of origin tied to different timetables for achieving a full customs union. For example, Bolivia has signed 26 agreements in all, each with different tariff rates, different exceptions and different rules of origin tied to different timetables with 6,000 tariff lines. This creates opportunities for customs officials to engage in rent-seeking. But these rules of origin may be less severe than in NAFTA. In fact, in the absence of these rules, these countries could have experienced faster growth in exports and imports and increased the tradability of these economies.
(d) A near free-trade situation exists among some of the Andean Group countries with common borders. For example, between Colombia and Venezuela, this trade has grown rapidly—perhaps the most rapid for any two counties in South America. This creates challenges for macroeconomic coordination. Earlier, when the trade links were not so strong, these two countries could well ignore their relative macroeconomic stances; but no longer.

(e) Finally, anti-dumping has increased rapidly in the past three years among regional groups. This is to be expected as other barriers are removed.

To summarize, Juan José has provided us an interesting paper. Its main finding that manufactures exports grew most rapidly within the group compared with the trade in these goods with other countries and groupings is an important finding. The other important finding is that the growth was even stronger in intra-industry trade. The reasons for the latter are not immediately known, and it is one that future research should attempt to understand better. Despite the increase in trade flows we are not in a position to make a welfare assessment of these developments. An important policy agenda remains to be addressed in the Andean Group, to secure greater gains from trade liberalizations. These include lowering the CET, reducing agriculture protection, eliminating the special automobile regime, recognizing the macroeconomic challenges that come along with greater integration, addressing remaining barriers that arise from rules of origin, and bringing anti-dumping under control.

Notes
IV. NAFTA
NAFTA: An Interim Report

J E F F R E Y J . S C H O T T

In June 1991, the United States, Canada and Mexico launched negotiations on a North American Free-Trade Agreement (NAFTA). The core agreement was signed by the three heads of state in Washington on December 17, 1992; the pact was then supplemented by three "side agreements," covering environment, labor issues and import surges, which were concluded in August 1993. The agreements entered into force on January 1, 1994.

In 1996, the NAFTA partners had a combined GDP of about $8.5 trillion and a population of about 380 million. The U.S. economy dominates the NAFTA region: The United States accounted for 89 percent of the NAFTA GDP and about 70 percent of the population.

NAFTA represents the culmination of decades of "silent" integration of the three economies of North America, reinforced by the negotiation of numerous bilateral trade agreements. By the time Mexico announced its interest in free-trade talks with the United States in 1990, the pathway to a prospective NAFTA had already been substantially cleared by prior trade accords, including:

- the U.S.-Canada Auto Pact of 1965;
- the U.S.-Mexico Understanding on Subsidies and Countervailing Duties of 1985;
- the U.S.-Mexico Framework of Principles and Procedures for Consultation regarding Trade and Investment Relations of 1987;
- the Canada-U.S. Free-trade Agreement (CUSFTA) of 1989;
- the U.S.-Mexico Understanding Regarding Trade and Investment Facilitation Talks of 1989; and
- ten Canada-Mexico bilateral accords, including a Framework for Trade and Investment Consultations, concluded in March 1990.

These arrangements were developed to support the growing regional network of trade and investment and to manage the bilateral disputes that inevitably arise as the volume of trade expands. Interestingly, U.S. bilateral initiatives with both its neighbors began with sectoral issues (autos, energy subsidies) but evolved soon after into broader trade and investment initiatives, reflecting the depth of common trade and investment interests among the North American countries.

By 1990, U.S. trade with Canada (merchandise and commercial services) surpassed $200 billion, U.S.-Mexico bilateral trade approached $75 billion, and Canada-Mexico trade ran at about $2.5 billion. U.S. and Canadian companies invested heavily (combined about $95 billion) in each other's economy, and U.S. investors accounted for about $10 billion in foreign direct investment (FDI) in Mexico. The United States already accounted for the predominant share of the trade of both Canada and Mexico, and of FDI in those countries. In short, North American economic integration was proceeding long before NAFTA negotiations were even broached, building on the new opportuni-
ties emerging from the domestic economic reforms in Mexico, introduced by the de la Madrid and Salinas governments, and the inflation- and budget-cutting initiatives in the United States and Canada.

NAFTA today is a work in progress. Many of its provisions have only recently been put into effect, and many of the important trade reforms have yet to be implemented. To date, NAFTA has required few changes in U.S. trade practices and regulations, although some obligations have been deferred (e.g., trucking regulations). Mexico has faced the more challenging task of introducing trade liberalization and regulatory reforms right from the start, and has persevered despite the peso crisis and severe recession that erupted less than a year after NAFTA went into effect.

**NAFTA Objectives**

The preamble and Article 102 of NAFTA spell out the concrete objectives that the three countries sought to achieve through the trade pact. In brief, the three countries sought to:

- promote increased regional trade and investment;
- “create new employment opportunities and improve working conditions and living standards in their respective territories’’;
- provide a framework for the conduct of trilateral trade relations and for the management of disputes;
- strengthen and enforce environmental laws and basic workers’ rights; and
- work together to promote “further trilateral, regional and multilateral cooperation to expand and enhance the benefits of this Agreement.”

This paper examines the progress to date in achieving these goals. Because it is difficult to parse out the direct effects of NAFTA provisions from the “normal” course of commerce between the three countries, I will generally report what has happened since NAFTA entered into force rather than what has happened because of the trade pact. The implementation of NAFTA provisions is only a small part of the story; in most respects, macroeconomic policy drives integration efforts in the NAFTA region. To put the Mexican experience under NAFTA into perspective, however, I first start with a few brief comments on the peso crisis.

**The Peso Crisis and Its Aftermath**

Mexico’s experience under NAFTA got off to an inauspicious start with the outbreak of the Chiapas uprising on January 1, 1994. Throughout the first year of NAFTA, the Mexican government was buffeted by a wave of political shocks that further complicated policymaking in that important election year. The story has been well told elsewhere (see DeLong et al. 1996; Lustig 1996). Suffice it to say that a combination of loose fiscal policy (statistically concealed in the public accounts), low private savings and an overvalued currency culminated in the peso crisis of December 1994, and in the subsequent sharp recession of 1995 with GDP falling by 6.2 percent.

In most respects, the Mexican crisis was homemade. NAFTA reforms bore scant responsibility for the developments that led to the liquidity crisis, except to the extent that expectations of continued capital inflows prompted by the “promise” of NAFTA-induced growth led Mexican officials into being unduly complacent about the overvalued peso. However, NAFTA was critical to the effective response to the crisis, in two important respects.

First, NAFTA obligations led President Zedillo to follow a highly orthodox recovery program: fiscal discipline, ultra-tight money and sharp exchange-rate devaluation. This program differed markedly from the extensive trade and capital controls usually deployed by developing countries in response to balance-of-payments problems. The pain in Mexico was exceedingly sharp, but the recovery to date has been noteworthy, especially compared with the prolonged crisis of 1982. In 1996, the Mexican economy grew by 5.1 percent in real terms and seems likely to exceed 7 percent growth in 1997.

The open access to the U.S. market, reinforced by NAFTA obligations, helped prevent an even more drastic recession in 1995: Net exports grew by more than 3 percent in 1995 and partially offset the 9.25 percent fall in domestic demand. The peso depreciation helped fuel the surge in net exports, but inflation quickly eroded much of the gain to Mexican exporters. Since the first half of 1996, however, Mexican growth has been led by a revival of domestic demand, primarily in the construction sector, which had experienced a 23.5 percent drop in output in 1995. Net exports increased by 1.1 percent while domestic demand grew by 6.2 percent in the second half of 1996.

Second, NAFTA partnership provided additional impetus for the Clinton administration to craft together a financial rescue package that helped Mexico restructure its short-term dollar-denominated debt and ease its liquidity crisis. The U.S. Treasury loans, totaling about $13.5 bil-
lion, were all repaid with interest ahead of schedule in January 1997.

**Trade and Investment**

By expanding trade and investment linkages between the industries of the three countries, the NAFTA partners hoped to create substantial synergies among the three economies that could generate important income and employment gains. The NAFTA reforms aimed to increase efficiency by encouraging each country to export those goods and services in which it had a comparative advantage, and to promote growth by generating more intense competition in each sector of the economy and allowing firms to take advantage of economies of scale of production in an expanded North American market.

**Trade**

NAFTA has contributed to a sharp expansion of regional trade, despite a temporary setback in 1995 caused by the Mexican recession. Over the period 1993 to 1996, U.S. exports to Mexico increased by 37 percent, and imports from Mexico by 83 percent. Except for the crisis year of 1995, U.S. merchandise trade with Mexico has grown substantially faster than trade with non-NAFTA countries. Total bilateral merchandise trade reached about $130 billion in 1996, more than double the amount transacted when NAFTA negotiations began in 1991 (Table 1).

Increased U.S. imports from Mexico resulted less from U.S. trade liberalization than from steady growth in the U.S. economy and heightened competition in the Mexican market due to a variety of economic reforms, including those resulting from NAFTA, which has forced Mexican firms to shape up and search out new trading opportunities at home and abroad. NAFTA has removed a few barriers to the U.S. market, notably in the textile and apparel sector, but average U.S. tariffs have been cut by less than 2 percentage points from already low levels, and tariffs on the most import-sensitive U.S. products (mostly agricultural) will not be removed for another 7 to 12 years. During NAFTA’s first three years, about one-quarter of the U.S. import growth from Mexico has been in motor vehicles (from $6 to $14 billion), textiles and apparel, and petroleum (reflecting higher prices, not NAFTA preferences).

Maquiladoras accounted for about 30 percent of the growth in total Mexican exports since 1994; maquila exports increased by an annual average of 18.5 percent from 1994 to 1996. Net maquila exports (i.e., less maquila imports) averaged $5.7 billion over this period. Interest-

### Table 1

**U.S.-Mexico Merchandise Trade, 1990–96**

*(in billions of U.S. dollars)*

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<tr>
<td><strong>U.S. Exports to Mexico</strong></td>
<td>28.3</td>
<td>33.3</td>
<td>40.6</td>
<td>41.6</td>
<td>50.8</td>
<td>46.3</td>
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<td>13.2</td>
<td>17.7</td>
<td>21.9</td>
<td>2.5</td>
<td>22.1</td>
<td>-8.9</td>
<td>22.7</td>
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<td>281.6</td>
<td>303.3</td>
<td>317.0</td>
<td>323.1</td>
<td>347.4</td>
<td>411.2</td>
<td>434.3</td>
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<tr>
<td>% change from previous year</td>
<td>8.3</td>
<td>7.7</td>
<td>4.3</td>
<td>1.9</td>
<td>7.5</td>
<td>18.4</td>
<td>5.6</td>
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<td><strong>U.S. Imports from Mexico</strong></td>
<td>30.2</td>
<td>31.1</td>
<td>35.2</td>
<td>39.9</td>
<td>49.5</td>
<td>61.7</td>
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<td>% change from previous year</td>
<td>11.0</td>
<td>3.0</td>
<td>13.2</td>
<td>13.4</td>
<td>24.1</td>
<td>26.4</td>
<td>18.5</td>
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<td>373.7</td>
<td>364.9</td>
<td>398.9</td>
<td>429.6</td>
<td>485.4</td>
<td>536.4</td>
<td>561.9</td>
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<td>% change from previous year</td>
<td>4.4</td>
<td>-2.4</td>
<td>9.3</td>
<td>7.7</td>
<td>13.0</td>
<td>10.3</td>
<td>4.8</td>
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<tr>
<td><strong>U.S. Balance of Merchandise</strong></td>
<td>-1.9</td>
<td>2.2</td>
<td>5.4</td>
<td>1.7</td>
<td>1.3</td>
<td>-15.4</td>
<td>-16.2</td>
</tr>
</tbody>
</table>

*Note: Canadian trade is excluded from the Rest of World Statistics.
Source: U.S. Department of Commerce, Bureau of Economic Analysis (Census Basis).*
ingly, manufactured exports of non-maquiladoras rose by an annual average of 35 percent, and generated 55 percent of the increase in total Mexican exports. Mexico was highly dependent on the U.S. market before NAFTA, and it has become even more reliant on U.S. sales; in 1996, trade with the United States accounted for 80 percent of total Mexican exports and imports (including maquilas), up from 75 percent in 1993. Over the period 1993–96, total Mexican trade with its NAFTA partners grew two-and-a-half times faster than trade with the rest of the world.

In contrast, and somewhat surprisingly, U.S.-Mexico services trade (including investment income) has not grown significantly, and the growth has been slower than trade with the rest of the world. The published data seem to indicate that NAFTA reforms in key sectors such as insurance and telecommunications have not yet generated new trade flows, although such data are often challenged for undercounting trade in business services. However, the sharp rise in regional FDI in these sectors (see below) may presage substantial trade growth in the coming years.

Canada-Mexico merchandise trade has also expanded sharply, albeit from a much lower base, and faster than Canadian trade with the rest of the non-NAFTA world. In 1996, bilateral trade exceeded $7 billion. During the period 1993 to 1996, Canadian exports grew by 47 percent—although growth has been virtually flat over the past two years (in contrast to strong growth in U.S. sales in 1996). Imports from Mexico have increased by 61 percent over this period.

U.S.-Canada merchandise trade has continued the robust expansion promoted by the Canada-U.S. Free-trade Agreement in 1989. Since NAFTA took effect, U.S.-Canadian trade has increased by 73 percent and totaled almost $300 billion in 1996. Here again, U.S. trade with Canada has grown faster than trade with non-NAFTA partners except in 1995 (Table 2).

CUSFTA and NAFTA reforms clearly contributed to the growth in bilateral trade. Industry-specific analysis by Daniel Schwanen (1997) reports that Canadian exports to the United States grew substantially faster in sectors that were liberalized under the trade pacts than sectors that were not affected by the agreements. More important, but harder to quantify, is the impact of tighter Canadian fiscal and monetary policy, and the more competitive Canadian dollar, which pressured Canadian firms to look south for market expansion and assisted them in doing so.

**Foreign Direct Investment**

One of the major Mexican objectives for negotiating NAFTA was to lock in, reinforce and augment the economic reforms implemented during the de la Madrid and Salinas administrations, in order to continue to encourage foreign investment in the Mexican economy. Mexico already had good access to the U.S. market, but the added “insurance” of negotiated trade obligations would provide additional incentives to domestic and foreign investors alike to expand their presence in the Mexican market as part of a broader strategy to rationalize production on a

<table>
<thead>
<tr>
<th>TABLE 2</th>
<th>U.S.-Canada Merchandise Trade, 1990–96</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Exports to Canada</td>
<td>83.7</td>
</tr>
<tr>
<td>% change from previous year</td>
<td>6.2</td>
</tr>
<tr>
<td>U.S. Exports to the Rest of the World</td>
<td>281.6</td>
</tr>
<tr>
<td>% change from previous year</td>
<td>8.3</td>
</tr>
<tr>
<td>U.S. Imports from Canada</td>
<td>91.4</td>
</tr>
<tr>
<td>% change from previous year</td>
<td>3.9</td>
</tr>
<tr>
<td>U.S. Imports from the Rest of the World</td>
<td>373.7</td>
</tr>
<tr>
<td>% change from previous year</td>
<td>4.9</td>
</tr>
<tr>
<td>U.S. Balance of Merchandise</td>
<td>-7.7</td>
</tr>
</tbody>
</table>

Note: Mexican trade is excluded from the Rest of World Statistics.

Source: U.S. Department of Commerce, Bureau of Economic Analysis (Census Basis).
regional scale. Mexico agreed to comprehensive investment rules and obligations that compare favorably to the "high standards" that OECD countries hope to establish in their ongoing negotiation on a Multilateral Agreement on Investment (see Graham 1996 for analysis of the investment provisions of each pact).

In contrast with the good economics of the Mexican position, the U.S. debate on NAFTA has been driven by xenophobic concerns resulting from bad economics. U.S. opponents of NAFTA raised the specter of a tidal wave of new U.S. investment in Mexico by footloose firms seeking to exploit cheap Mexican labor. Ross Perot heard a "giant sucking sound" of U.S. jobs being shifted south of the border. These concerns resonated well in the public debate due to the insecurity of U.S. workers about the massive restructuring of major U.S. companies over the past decade and the growing adjustment pressures generated by globalization.

In fact, the giant sucking sound has yet to be heard. NAFTA has had little impact on investment in the United States and reinforced only marginally already small but significant U.S. investment in Mexico. Data for actual disbursements of U.S. funds in Mexico from January 1994 through June 1996 indicate that U.S. FDI averaged about $4.4 billion annually in 1994 and 1995, and was running at about half that rate in the first half of 1996.4 Half of those investments were in the manufacturing sector; 17 percent were in financial services, reflecting perhaps the accelerated opening of that sector instituted as part of the response to the peso crisis and ensuing recession. Contrary to the claims of NAFTA critics, U.S. FDI in Mexico represents a small fraction of U.S. gross investment in plants and equipment (which amounted to about $785 billion in 1996).

Similarly, the combined effect of CUSFTA and NAFTA on FDI in Canada has mattered less than the progress made in dampening inflation and reining in the budget deficit since the early 1990s. Over the period 1990–95, total FDI in Canada rose 28 percent to C$168 billion on a historical cost basis; U.S. FDI accounted for two-thirds of that total in 1995. The stock of U.S. FDI in Canada grew twice as fast as FDI from the rest of the world combined.

The Mexican story is more complex and harder to decipher because of both the peso crisis and 1995 recession, and because of changes in SECOFI's reporting practices, which make it difficult to compare NAFTA results with FDI inflows before 1994. To be sure, NAFTA has made it easier to invest in Mexico by cutting red tape and removing key ownership restrictions, particularly in the financial services industries. Nonetheless, companies won't invest unless they believe the climate for economic growth (and for making profits) is favorable over a reasonable period of time.

Have companies altered their investment strategies in light of NAFTA? A survey of more than 400 firms in Mexico (about half of which were U.S.-owned) conducted by the American Chamber of Commerce of Mexico in November 1996 reported that 56 percent of respondents replied "yes" to that general question, including 70 percent of the larger firms and two-thirds of the non-U.S. foreign companies. In contrast, only 46 percent of small companies and 52 percent of Mexican companies indicated that NAFTA affected their strategies. Interestingly, two-thirds of the respondents said NAFTA had not led them to shift production from other foreign countries to the NAFTA region.

Based on balance-of-payments data reported by the Bank of Mexico, one can see a strong trend toward increased FDI in Mexico since the late 1980s. Annual FDI flows averaged $2.9 billion annually over the period 1988–90, $4.5 billion annually from 1991–93, and $9.4 billion annually under NAFTA from 1994–96. Historically, the United States has accounted for more than 60 percent of FDI in Mexico, followed by Germany and the United Kingdom, with about 6 percent each (Hufbauer and Schott 1992, p. 74). Since NAFTA entered into force, however, the U.S. share in new FDI in Mexico has fallen to 53 percent. Several factors may be at play.

First, NAFTA clearly has had a positive influence on North American investment in Mexico; the NAFTA share of total FDI invested in Mexico from 1994 through June 1996 was almost 60 percent (Riner and Sweeney 1997, Table 6). U.S. and Canadian firms accounted for more than two-thirds of the foreign companies operating in Mexico as of June 1996 (about 80 percent of these firms were majority-owned). Canada has substantially increased its investments in Mexico in both financial services and manufacturing, and accounted for 6.3 percent of new FDI in Mexico since the start of 1994 (compared with about 1 percent pre-NAFTA).

Second, some previously small investors (e.g., India and the Netherlands) made substantial investments in 1995 that gave them a share of new FDI since NAFTA entered into force of 8.3 percent and 6.5 percent, respectively. It is
unclear whether these are one-off projects or whether they portend heightened interest in the Mexican market from a broader array of foreign investors. The peso crisis may have spurred a fire-sale of some Mexican assets in 1995: More than $10 billion in new investments were approved in that record year (Table 3). In that regard, the insurance policy value of NAFTA probably contributed to the decision to invest, despite the economic problems at that time, by reinforcing expectations of a durable recovery over the medium term.

The sectoral distribution of new FDI in Mexico since NAFTA entered into force seems to have refocused on manufacturing industries (especially machinery and equipment, processed farm products and metals) and on financial services (which accounts for almost half of all FDI in the services sector). FDI in manufacturing industries represented 57 percent of new FDI since 1994, while 21 percent of new FDI went into services, compared with shares of 52 percent and 37 percent respectively for FDI stocks in these sectors prior to NAFTA in 1993 on a historical cost basis.

Impact on Third Countries

NAFTA was designed to adversely affect the trade of third-country suppliers by strengthening the ability of domestic industries to compete in both regional and global markets. That said, NAFTA represents only one part, and a small one at that, of the package of economic initiatives that each member country has undertaken to improve productivity and promote higher living standards for its people. Determining the impact of NAFTA preferences on foreign trade is further clouded by the peso crisis and severe Mexican recession of 1995, which resulted in a decline in total Mexican imports that year of about 9 percent (although imports from its NAFTA partners fell only 2 percent). How much of this difference is due to NAFTA preferences versus other factors requires an industry-specific analysis that is beyond the scope of this short paper.

Nonetheless, the available trade data allow a rough analysis of the impact of NAFTA preferences in one important sector. When NAFTA was first negotiated, concerns about trade diversion focused primarily on the potential adverse effect of restrictive rules of origin on third-country imports of textiles and apparel sector into the U.S. market. The U.S. market remains protected by quotas (which will not be fully phased out until 2005 under the Uruguay Round reform of the Multi-Fiber Arrangement) and high tariffs. Mexico and countries participating in the Caribbean Basin Initiative (CBI) benefited from significant trade preferences prior to NAFTA, so the NAFTA preferences have had only a small additional impact on foreign suppliers already facing discrimination in the U.S. market. However, as a result of NAFTA, Mexico now receives better special treatment in the U.S. market than the CBI countries. A quick look at the trade numbers tells the story.

Table 4 reports the growth in the value of U.S. imports of textiles and apparel from 1993 to 1996. Total U.S. imports during this period increased by almost $10 billion; the NAFTA region accounted for 39 percent of this growth and the CBI region for 21 percent. Imports from Mexico more than tripled; imports from Canada increased by a more "modest" rate of 96 percent; and total imports from the CBI region were up by 50 percent. In contrast, countries with which the United States concluded highly restrictive bilateral quota agreements—China, Hong Kong, Taiwan and South Korea—experienced flat to sharply lower sales in the U.S. market. As a result, the NAFTA and CBI regions supplied in 1996 a greater share of U.S. imports (27 percent) than China, Hong Kong, and Taiwan combined (25 percent).

As shown in Table 5, both Mexico and the CBI region benefited significantly from U.S. trade preferences under the in-bond duty programs (HTS 9802). Mexican shipments under this program increased by $2 billion (or 180 percent) and accounted for 70 percent of the growth in the value of U.S. imports of Mexican textiles and apparel over

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The table below shows the balance of payments authorized by Mexican FDI inflows for the years 1988 to 1996.

<table>
<thead>
<tr>
<th>Year</th>
<th>Balance of Payments</th>
<th>Authorized FDI</th>
</tr>
</thead>
<tbody>
<tr>
<td>1988</td>
<td>2.9</td>
<td>3.2</td>
</tr>
<tr>
<td>1989</td>
<td>3.2</td>
<td>3.6</td>
</tr>
<tr>
<td>1990</td>
<td>2.6</td>
<td>3.7</td>
</tr>
<tr>
<td>1991</td>
<td>4.8</td>
<td>3.6</td>
</tr>
<tr>
<td>1992</td>
<td>4.4</td>
<td>5.7</td>
</tr>
<tr>
<td>1993</td>
<td>4.4</td>
<td>4.9</td>
</tr>
<tr>
<td>1994</td>
<td>11.0</td>
<td>8.4</td>
</tr>
<tr>
<td>1995</td>
<td>9.3</td>
<td>10.4</td>
</tr>
<tr>
<td>1996</td>
<td>7.6</td>
<td>7.9</td>
</tr>
</tbody>
</table>

* Based on January–June data. 
Source: Bank of Mexico (1996, 1997) for BOP data; Riner and Sweeney (1997) for data on FDI authorized by SECOFI.
TABLE 4

U.S. Imports of Textiles and Apparel
(in millions of U.S. dollars)

<table>
<thead>
<tr>
<th></th>
<th>1993</th>
<th>1996</th>
<th>CHANGE (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>36,079</td>
<td>45,953</td>
<td>27.3</td>
</tr>
<tr>
<td>NAFTA</td>
<td>2,392</td>
<td>6,227</td>
<td>160.3</td>
</tr>
<tr>
<td>Mexico</td>
<td>1,372</td>
<td>4,232</td>
<td>208.5</td>
</tr>
<tr>
<td>Canada</td>
<td>1,020</td>
<td>1,993</td>
<td>95.6</td>
</tr>
<tr>
<td>CBI</td>
<td>4,064</td>
<td>6,107</td>
<td>50.3</td>
</tr>
<tr>
<td>Dominican Republic</td>
<td>1,458</td>
<td>1,802</td>
<td>23.6</td>
</tr>
<tr>
<td>Honduras</td>
<td>508</td>
<td>1,223</td>
<td>140.7</td>
</tr>
<tr>
<td>China</td>
<td>4,767</td>
<td>4,892</td>
<td>2.6</td>
</tr>
<tr>
<td>Hong Kong, China</td>
<td>3,957</td>
<td>4,031</td>
<td>1.9</td>
</tr>
<tr>
<td>Taiwan, China</td>
<td>2,861</td>
<td>2,733</td>
<td>-4.3</td>
</tr>
<tr>
<td>Rep. of Korea</td>
<td>2,477</td>
<td>2,049</td>
<td>-17.3</td>
</tr>
<tr>
<td>India</td>
<td>1,286</td>
<td>1,737</td>
<td>35.1</td>
</tr>
<tr>
<td>Italy</td>
<td>1,048</td>
<td>1,703</td>
<td>62.5</td>
</tr>
</tbody>
</table>


the period 1993–96. Similarly, CBI imports also increased by almost $2 billion (or 60 percent), accounting for 92 percent of the growth in shipments from that region. If these trends continue, Mexico could soon replace the CBI region as the major supplier of the U.S. market—provoking CBI concern that NAFTA preferences, unless offset by “NAFTA parity” legislation for the CBI region, will result in the diversion of investment in this sector to Mexico.

If trade preferences are the cause of this growth, one would expect that other countries would not sharply increase sales to the U.S. market in categories in which Mexican shipments have recorded the strongest growth (Table 6). However, the evidence from these disaggregated data is not crystal clear. More than half of the growth in Mexican shipments to the United States over the period 1993–96 came in three product sectors: men’s and women’s cotton trousers, cotton knit shirts and knit shirts from man-made fibers. Mexico accounted for more than 60 percent of the growth in total U.S. imports of cotton trousers (MFA categories 347/348) as sales tripled to $1.3 billion in 1996; Mexico’s import share consequently rose from 12 percent in 1993 to 24 percent in 1996. U.S. imports of these products from the three main CBI suppliers (Dominican Republic, Honduras and Guatemala) also increased but at a slower pace (14.5 percent); their import market share also fell from 17.5 percent to 16.9 percent.

Effects on Jobs and Wages

President Clinton sold NAFTA as an engine of job creation. His expansive claims counterbalanced the provocative forecasts by NAFTA critics that the trade pact would result in massive job losses in the U.S. economy. In the event, neither side was right, nor could they be. Trade agreements can affect the composition of employment, causing some industries to expand and others to contract, but they will not cause the overall level of employment to be appreciably higher or lower than the central bank deems appropriate.

TABLE 5

U.S. Imports of Textiles and Apparel Subject to HTS 9802 Preferences
(in millions of U.S. dollars)

<table>
<thead>
<tr>
<th>SOURCE</th>
<th>1993</th>
<th>1996</th>
<th>CHANGE (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>4,813</td>
<td>8,887</td>
<td>84.6</td>
</tr>
<tr>
<td>Mexico</td>
<td>1,104</td>
<td>3,100</td>
<td>180.8</td>
</tr>
<tr>
<td>CBI Region</td>
<td>3,134</td>
<td>5,009</td>
<td>59.8</td>
</tr>
</tbody>
</table>


TABLE 6

Sources of Growth of U.S. Imports from Mexico, 1993–96
(in millions of U.S. dollars)

<table>
<thead>
<tr>
<th>MFA CATEGORY</th>
<th>1993</th>
<th>1996</th>
<th>INCREASE ($)</th>
</tr>
</thead>
<tbody>
<tr>
<td>347/348: Men’s &amp; Women’s Cotton Trousers</td>
<td>459</td>
<td>1,259</td>
<td>800</td>
</tr>
<tr>
<td>338/339: Men’s &amp; Women’s Cotton Knit Shirts</td>
<td>81</td>
<td>456</td>
<td>375</td>
</tr>
<tr>
<td>638/639: Men’s &amp; Women’s Knit Shirts (man-made fibers)</td>
<td>65</td>
<td>384</td>
<td>319</td>
</tr>
<tr>
<td>647/648: Men’s &amp; Women’s Trousers (man-made fibers)</td>
<td>64</td>
<td>257</td>
<td>193</td>
</tr>
<tr>
<td>649: Brassieres (man-made fibers)</td>
<td>97</td>
<td>167</td>
<td>70</td>
</tr>
<tr>
<td>352: Cotton Underwear</td>
<td>38</td>
<td>120</td>
<td>82</td>
</tr>
</tbody>
</table>

Subtotal    | 804   | 2,643 | 1,839
Other       | 568   | 1,389 | 1,021
Total       | 1,372 | 4,232 | 2,860

Since NAFTA entered into force in January 1994, total U.S. employment increased by 6.7 million workers (almost all full-time positions) or by about 2.2 million per year; employment in the U.S. manufacturing industries remained about the same; and the unemployment rate fell below 5 percent (Table 7). Even the auto sector (SIC 371), which ran a large trade deficit with Mexico and Canada, experienced significant employment gains over this period. At the same time, about 1.5 million workers annually lost their jobs because of technological change, slack demand, import competition etc. Thus, gross U.S. job creation was 3.7 million per year (3.7 less 1.5 = 2.2).

What impact has NAFTA had on these developments? Given the size of the U.S. civilian labor force (about 130 million), the answer must be "not much." One cannot differentiate jobs dedicated to exports from those producing for the domestic market, but the overall impact on U.S. employment of increased NAFTA trade must be minimal given the magnitude of trade compared with the domestic economy. The only hard data available are the number of workers certified for NAFTA Transitional Adjustment Assistance because their jobs were abolished by firms that moved to Mexico or Canada, or by firms that lost sales to Mexican or Canadian imports. As of March 1997, a total of 117,000 workers were certified under the NAFTA program, or about 39,000 per year—a very small share of the annual total of 1.5 million job displacements in the U.S. economy (Table 8).

U.S. critics of NAFTA also argue that the pact will suppress increases in real wages (in both countries) and will increase the gap between skilled and unskilled workers. Cline (1997, p. 257), however, notes that freer trade (and immigration) at best may be responsible for 20 to 25 percent of the increase in the differential between these groups in the U.S. economy over the past two decades. To be sure, average hourly earnings in U.S. manufacturing has remained flat since January 1994 (Table 9). However, to the extent that NAFTA increased overall U.S. exports, it will have had a small positive effect on U.S. wages, because workers in the U.S. export sector earn about 10 to 15 percent more than those in non-exporting firms (Richardson and Rindal 1996); this annual export wage premium amounts to more than $4,000 per worker in 1997.

The Mexican experience, in contrast, is dominated by the combined shocks of the peso crisis and subsequent recession. Average real wages in the Mexican manufacturing sector fell by about 19 percent during the period 1993–96, despite impressive 7 percent annual gains in worker productivity. At their peak in 1994, real wages were about 40 percent higher than in 1987, but in 1997 were less than 10 percent higher than the level of 1987.

**Dispute Settlement**

Close friends and trading partners inevitably have differences, and the number of trade disputes invariably rises as trade volumes expand. This maxim has proved true in the

---

**TABLE 7**

**U.S. Employment, 1994 IQ to 1997 IQ**

<table>
<thead>
<tr>
<th>(in millions)</th>
<th>TOTAL EMPLOYED</th>
<th>FULL-TIME</th>
<th>PART-TIME</th>
<th>MANUFACTURING (ANNUAL AVG.)</th>
<th>TOTAL UNEMPLOYED</th>
<th>RATE (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994 (I)</td>
<td>122.0</td>
<td>98.4</td>
<td>23.6</td>
<td>18.32</td>
<td>8.6</td>
<td>6.6</td>
</tr>
<tr>
<td>(II)</td>
<td>122.6</td>
<td>99.4</td>
<td>23.1</td>
<td>18.47</td>
<td>8.0</td>
<td>6.2</td>
</tr>
<tr>
<td>(III)</td>
<td>123.2</td>
<td>100.3</td>
<td>23.0</td>
<td></td>
<td>7.9</td>
<td>6.0</td>
</tr>
<tr>
<td>(IV)</td>
<td>124.4</td>
<td>101.0</td>
<td>23.5</td>
<td></td>
<td>7.4</td>
<td>5.6</td>
</tr>
<tr>
<td>1995 (I)</td>
<td>124.9</td>
<td>101.4</td>
<td>23.5</td>
<td>18.47</td>
<td>7.3</td>
<td>5.5</td>
</tr>
<tr>
<td>(II)</td>
<td>124.7</td>
<td>101.5</td>
<td>23.2</td>
<td></td>
<td>7.3</td>
<td>5.6</td>
</tr>
<tr>
<td>(III)</td>
<td>124.8</td>
<td>101.7</td>
<td>23.2</td>
<td></td>
<td>7.5</td>
<td>5.7</td>
</tr>
<tr>
<td>(IV)</td>
<td>125.1</td>
<td>102.1</td>
<td>23.1</td>
<td></td>
<td>7.4</td>
<td>5.6</td>
</tr>
<tr>
<td>1996 (I)</td>
<td>125.7</td>
<td>102.5</td>
<td>23.2</td>
<td>18.28</td>
<td>7.3</td>
<td>5.6</td>
</tr>
<tr>
<td>(II)</td>
<td>126.4</td>
<td>103.2</td>
<td>23.1</td>
<td></td>
<td>7.3</td>
<td>5.4</td>
</tr>
<tr>
<td>(III)</td>
<td>127.0</td>
<td>103.9</td>
<td>23.2</td>
<td></td>
<td>7.1</td>
<td>5.3</td>
</tr>
<tr>
<td>(IV)</td>
<td>127.7</td>
<td>104.6</td>
<td>23.1</td>
<td></td>
<td>7.1</td>
<td>5.3</td>
</tr>
<tr>
<td>1997 (I)</td>
<td>128.7</td>
<td>105.3</td>
<td>23.3</td>
<td>18.30</td>
<td>7.2</td>
<td>5.3</td>
</tr>
</tbody>
</table>

that reason, NAFTA incorporated dispute-settlement provisions that help to assuage concerns in those countries about continued good access to the dominant market in the region, the United States.

Given the relative openness of the U.S. market, the major source of concern by Canada and Mexico with regard to market access has been the introduction of new protection through the administration of U.S. unfair trade statutes (especially via anti-dumping and countervailing duties). Historically, both countries have been the target of numerous U.S. cases and consequently placed high priority on incorporating new disciplines on these practices in the NAFTA. For example, Canada faced 70 U.S. anti-dumping or countervailing duty cases over the past three decades, although their frequency has declined sharply since a rash of steel cases in the early 1990s.

The Canada-U.S. Free-Trade Agreement sought to limit trade frictions in this area by creating a new dispute mechanism (in CUSFTA Chapter 19) to review the final determinations of national trade authorities that allegedly did not follow the rules of national legislation. This mechanism was then incorporated in NAFTA (also Chapter 19) after Mexico agreed to overhaul its laws and regulations to conform more closely to U.S. and Canadian norms. Note that this dispute mechanism does not exempt Canada and Mexico from U.S. anti-dumping cases, but does provide a more expeditious procedure than lengthy court challenges for resolving disputes regarding alleged problems in the administration of those laws in each country.

Tables 10 and 11 document the cases that have been brought before dispute panels under the provisions of NAFTA Chapter 19. From January 1994 through April 1997, NAFTA panels have been convened in 26 cases (of which decisions are pending in four cases). The United States has been the most active complainant (13 cases) and the country most subject to complaint (10 cases). Canada and Mexico have also been frequently on both sides of the docket. Complaints against Mexico generally cite problems with the administration of the new anti-dumping rules by the SECOFI bureaucrats, while U.S. and Canadian cases often involve more arcane problems related to the interpretation of the dense complex of national anti-dumping and countervailing duty laws and regulations. Several general observations on this process bear mention.

First, the cases have been handled expeditiously (compared with judicial review of final determinations by

### Table 8

<table>
<thead>
<tr>
<th>Year</th>
<th>CANADA</th>
<th>MEXICO</th>
<th>UNIDENTIFIED</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994 (I)</td>
<td>543</td>
<td>980</td>
<td>0</td>
<td>1,523</td>
</tr>
<tr>
<td>(II)</td>
<td>1,144</td>
<td>2,599</td>
<td>0</td>
<td>3,743</td>
</tr>
<tr>
<td>(III)</td>
<td>890</td>
<td>4,330</td>
<td>408</td>
<td>5,828</td>
</tr>
<tr>
<td>(IV)</td>
<td>4,162</td>
<td>4,232</td>
<td>1,257</td>
<td>9,651</td>
</tr>
<tr>
<td>1995 (I)</td>
<td>1,324</td>
<td>3,124</td>
<td>1,471</td>
<td>5,919</td>
</tr>
<tr>
<td>(II)</td>
<td>3,488</td>
<td>4,228</td>
<td>834</td>
<td>8,550</td>
</tr>
<tr>
<td>(III)</td>
<td>2,473</td>
<td>2,475</td>
<td>2,458</td>
<td>7,406</td>
</tr>
<tr>
<td>(IV)</td>
<td>3,497</td>
<td>6,564</td>
<td>1,557</td>
<td>11,618</td>
</tr>
<tr>
<td>1996 (I)</td>
<td>1,692</td>
<td>7,148</td>
<td>2,433</td>
<td>11,245</td>
</tr>
<tr>
<td>(II)</td>
<td>1,672</td>
<td>9,550</td>
<td>2,903</td>
<td>14,125</td>
</tr>
<tr>
<td>(III)</td>
<td>747</td>
<td>6,062</td>
<td>2,645</td>
<td>9,454</td>
</tr>
<tr>
<td>(IV)</td>
<td>941</td>
<td>8,407</td>
<td>757</td>
<td>10,105</td>
</tr>
<tr>
<td>1997 (I)</td>
<td>1,169</td>
<td>12,575</td>
<td>3,305</td>
<td>17,049</td>
</tr>
<tr>
<td>Total</td>
<td>23,742</td>
<td>72,744</td>
<td>20,030</td>
<td>116,516</td>
</tr>
</tbody>
</table>

**Note:** Assistance provided when jobs lost either because of a shift in production to Canada/Mexico or because of increased imports from Canada/Mexico (whether or not the increase was attributable to tariff cuts under NAFTA).

**Source:** U.S. Department of Labor, Office of Trade Adjustment Assistance database.

### Table 9

**Average Hourly Earnings: Manufacturing**

<table>
<thead>
<tr>
<th>Month</th>
<th>CURRENT $</th>
<th>CONSTANT $</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>(1982)</td>
</tr>
<tr>
<td>1994</td>
<td></td>
<td></td>
</tr>
<tr>
<td>January</td>
<td>11.96</td>
<td>8.07</td>
</tr>
<tr>
<td>February</td>
<td>12.00</td>
<td>8.08</td>
</tr>
<tr>
<td>March</td>
<td>11.99</td>
<td>8.05</td>
</tr>
<tr>
<td>Annual Avg.</td>
<td>12.06</td>
<td>8.02</td>
</tr>
<tr>
<td>1995</td>
<td></td>
<td></td>
</tr>
<tr>
<td>January</td>
<td>12.24</td>
<td>8.03</td>
</tr>
<tr>
<td>February</td>
<td>12.24</td>
<td>8.00</td>
</tr>
<tr>
<td>March</td>
<td>12.25</td>
<td>7.98</td>
</tr>
<tr>
<td>Annual Avg.</td>
<td>12.35</td>
<td>7.99</td>
</tr>
<tr>
<td>1996</td>
<td></td>
<td></td>
</tr>
<tr>
<td>January</td>
<td>12.64</td>
<td>8.07</td>
</tr>
<tr>
<td>February</td>
<td>12.57</td>
<td>8.00</td>
</tr>
<tr>
<td>March</td>
<td>12.54</td>
<td>7.95</td>
</tr>
<tr>
<td>Annual Avg.</td>
<td>12.78</td>
<td>8.04</td>
</tr>
<tr>
<td>1997</td>
<td></td>
<td></td>
</tr>
<tr>
<td>January</td>
<td>13.04</td>
<td>8.08</td>
</tr>
<tr>
<td>February</td>
<td>13.03</td>
<td>8.05</td>
</tr>
<tr>
<td>March</td>
<td>13.09</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

**Source:** U.S. Department of Labor, BLS, Employment and Earnings (April 1997); Table B-17, Average Hourly & Weekly Earnings of Production or Nonsupervisory Workers on Private Nonfarm Payrolls.
<table>
<thead>
<tr>
<th>DISPUTE ACTION</th>
<th>COMPLAINANT</th>
<th>OUTCOME</th>
</tr>
</thead>
<tbody>
<tr>
<td>CDA-94-1904-01</td>
<td>Certain Fresh, Whole, Delicious, Red Delicious and Golden Delicious Apples, Originating in or Exported from the United States, Excluding Delicious, Red Delicious and Golden Delicious Apples Imported in Non-Standard Containers for Processing (injury determination)</td>
<td>Canadian producers</td>
</tr>
<tr>
<td>CDA-94-1904-02</td>
<td>Synthetic Baler Twine with a Knot Strength of 200 lbs. or less, from the United States (injury determination)</td>
<td>U.S. producer/exporter and Canadian importer</td>
</tr>
<tr>
<td>CDA-94-1904-03</td>
<td>Certain Corrosion-Resistant Steel Sheet Products from the United States (dumping determination)</td>
<td>U.S. producers</td>
</tr>
<tr>
<td>CDA-94-1909-04</td>
<td>Certain Corrosion-Resistant Steel Sheet Products, originating in or exported from the United States (injury determination)</td>
<td>U.S. producers</td>
</tr>
<tr>
<td>MEX-94-1904-01</td>
<td>Flat-Coated Steel Products from the United States (dumping determination)</td>
<td>U.S. producers</td>
</tr>
<tr>
<td>MEX-94-1904-02</td>
<td>Imports of Cut-length Plate Producers from the United States (dumping determination)</td>
<td>U.S. producers</td>
</tr>
<tr>
<td>MEX-94-1904-03</td>
<td>Crystal and Solid Polystyrene from the United States (dumping determination)</td>
<td>U.S. and Mexican producers</td>
</tr>
<tr>
<td>USA-94-1904-01</td>
<td>Live Swine from Canada, (CVD Administrative Review)</td>
<td>Canadian producers</td>
</tr>
<tr>
<td>USA-94-1904-02</td>
<td>Leather Wearing Apparel from Mexico (CVD Administrative Review)</td>
<td>Mexican producers</td>
</tr>
<tr>
<td>CDA-95-1904-01</td>
<td>Certain Malt Beverages from the United States (injury determination)</td>
<td>U.S. producers</td>
</tr>
<tr>
<td>CDA-95-1904-02</td>
<td>Fresh, Whole, Delicious, Red Delicious and Golden Delicious Apples, Originating in or Exported from the United States (dumping determination)</td>
<td>U.S. exporters</td>
</tr>
<tr>
<td>CDA-95-1904-03</td>
<td>Machine Tufted Carpeting originating in or exported from the United States (dumping determination)</td>
<td>U.S. producers</td>
</tr>
<tr>
<td>DISPUTE ACTION</td>
<td>COMPLAINANT</td>
<td>OUTCOME</td>
</tr>
<tr>
<td>----------------</td>
<td>-------------</td>
<td>---------</td>
</tr>
<tr>
<td>CDA-95-1904-04</td>
<td>Refined sugar originating in or exported from the United States (dumping determination)</td>
<td>U.S. exporter</td>
</tr>
<tr>
<td>MEX-95-1904-01</td>
<td>Seamless Steel Tube originating in the United States (dumping determination)</td>
<td>U.S. producers</td>
</tr>
<tr>
<td>USA-95-1904-01</td>
<td>Porcelain-on-Steel Cookware from Mexico (AD administrative review)</td>
<td>Mexican producers</td>
</tr>
<tr>
<td>USA-95-1904-02</td>
<td>Gray Portland Cement and Cement Clinker from Mexico (AD administrative review)</td>
<td>Mexican producers</td>
</tr>
<tr>
<td>USA-95-1904-03</td>
<td>Color Picture Tubes from Canada (dumping determination)</td>
<td>Canadian exporters</td>
</tr>
<tr>
<td>USA-95-1904-04</td>
<td>Oil Country Tubular Goods from Mexico (dumping determination)</td>
<td>Mexican and U.S. producers</td>
</tr>
<tr>
<td>USA-95-1904-05</td>
<td>Fresh Cut Flowers from Mexico (AD administrative review)</td>
<td>Mexican producers</td>
</tr>
<tr>
<td>CDA-96-1904-01</td>
<td>Bacteriological Culture Media from Becton Dickinson and Company and Difco Laboratories of the United States and from Unipath Limited of the United Kingdom (dumping determination)</td>
<td>U.S. producers</td>
</tr>
<tr>
<td>MEX-96-1904-01</td>
<td>Cold Rolled Sheet from Canada</td>
<td>Canadian producers</td>
</tr>
<tr>
<td>MEX-96-1904-02</td>
<td>Rolled Steel Plate from Canada</td>
<td>Canadian producers</td>
</tr>
<tr>
<td>MEX-96-1904-03</td>
<td>Hot Rolled Steel Sheet from Canada</td>
<td>Canadian producers</td>
</tr>
<tr>
<td>USA-96-1904-01</td>
<td>Porcelain-on-Steel Cooking Ware from Mexico</td>
<td>U.S. producers</td>
</tr>
<tr>
<td>USA-97-1904-01</td>
<td>Gray Portland Cement and Clinker from Mexico 5th AD Administrative Review</td>
<td>Mexican producers</td>
</tr>
</tbody>
</table>

TABLE 1

NAFTA Disputes under Chapter 19: January 1994 to May 1997

<table>
<thead>
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<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>6</td>
<td>5</td>
<td>2</td>
<td>0</td>
<td>13</td>
</tr>
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<td>Canada</td>
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<td>1</td>
<td>3</td>
<td>0</td>
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<tr>
<td>Mexico</td>
<td>1</td>
<td>4</td>
<td>0</td>
<td>2</td>
<td>7</td>
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<table>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>2</td>
<td>5</td>
<td>1</td>
<td>2</td>
<td>10</td>
</tr>
<tr>
<td>Canada</td>
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<td>0</td>
<td>9</td>
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<tr>
<td>Mexico</td>
<td>3</td>
<td>1</td>
<td>3</td>
<td>0</td>
<td>7</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Review Terminated</td>
<td>0</td>
<td>3</td>
<td>2</td>
<td>0</td>
<td>5</td>
</tr>
<tr>
<td>Decision Remanded in Whole or Part</td>
<td>3</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>5</td>
</tr>
<tr>
<td>Action Reaffirmed</td>
<td>2</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OUTCOME OF CANADIAN COMPLAINTS</th>
<th>1994</th>
<th>1995</th>
<th>1996</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Review Terminated</td>
<td>1</td>
<td>0</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Decision Remanded in Whole or Part</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Action Reaffirmed</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OUTCOME OF MEXICAN COMPLAINTS</th>
<th>1994</th>
<th>1995</th>
<th>1996</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Review Terminated</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Decision Remanded in Whole or Part</td>
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<td>3</td>
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<td>3</td>
</tr>
<tr>
<td>Action Reaffirmed</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

a. MEX-95-1904-02 decision due; b. USA-97-1904-01 decision due.

national agencies) and objectively. Most panels report within or close to the requisite time periods, and panel voting has in most instances not fallen along nationality lines.

Second, most of the disputes have been resolved on a "technical" track, without resort to political negotiations (the U.S.-Canada softwood lumber case is a notable exception). The panels do not "rubber stamp" the decisions of national agencies; indeed, in about 40 percent of their decisions (nine of 22) the panel has remanded the case in whole or part to the national agency.

NAFTA contains other dispute-resolution mechanisms and allows member countries to choose between regional and multilateral forums. However, to date, only four disputes between NAFTA partners have been brought to the WTO (Table 12). Eight cases have been brought under the general GATT-like procedures of NAFTA Chapter 20, involving politically sensitive issues such as trucking, the Helms-Burton sanctions against Cuba and Mexican tomatoes, which have provoked consultations but few agreements among the partner countries (Table 13). Interestingly, the NAFTA investment chapter contains path-breaking procedures for the resolution of investment disputes, including new rights for private parties to obtain relief directly against governments for NAFTA violations.

**NAFTA Agreements on the Environment and Labor**

To assuage domestic concerns about the impact of NAFTA on labor and the environment, and to bolster support in his own party for the pact, President Clinton insisted that the NAFTA partners supplement their free-trade agreement with additional obligations relating to labor and the environment. The North American Agreement on Environmental Cooperation (NAAEC) and the North American Agreement on Labor Cooperation (NAALC) were concluded in August 1993 and entered into force as side agreements to NAFTA. In addition, the United States and Mexico concluded a Border Environmental Cooperation Agreement that seeks to promote new investment in environmental infrastructure (primarily in the border region), and establishes a North American Development Bank (NADBank) to channel additional public resources for those purposes.
### TABLE 12
**Trade Disputes Brought by the NAFTA Countries in the WTO**

<table>
<thead>
<tr>
<th>DISPUTE ACTION</th>
<th>COMPLAINANT</th>
<th>CONSULTATION REQUESTED</th>
<th>OUTCOME</th>
</tr>
</thead>
<tbody>
<tr>
<td>WT/DS 49</td>
<td>Mexico</td>
<td>7-Jul-96</td>
<td>In October 1996, the U.S. Department of Commerce and Mexican exporters signed an agreement suspending the anti-dumping investigation.</td>
</tr>
<tr>
<td>WT/DS 101</td>
<td>United States</td>
<td>4-Sep-97</td>
<td>Consultations pending</td>
</tr>
<tr>
<td>WT/DS 103</td>
<td>United States</td>
<td>8-Oct-97</td>
<td>Consultations pending</td>
</tr>
</tbody>
</table>

In essence, the NAAEC and the NAALC have two broad-ranging objectives. First, the pacts monitor implementation of national laws and regulations in each country pertaining to labor and the environment. In effect, the NAAEC and the NAALC serve a watchdog role, alerting countries to simmering abuses of labor and environmental practices within each country so that the problems can be resolved before they grow into trans-boundary disputes. Second, the pacts establish a forum for consultations and dispute resolution in cases where domestic enforcement is inadequate.

To date, the side agreements do not have a stellar track record. Setting up the administrative machinery to implement the pacts has been a slow and cumbersome process. The dispute-resolution procedures have begun to be used, with some positive results, but the pacts have been less suc-

### TABLE 13
**NAFTA Chapter 20 Panel Reviews, January 1994 to March 1997**

<table>
<thead>
<tr>
<th>DISPUTE ACTION</th>
<th>COMPLAINANT</th>
<th>OUTCOME</th>
</tr>
</thead>
<tbody>
<tr>
<td>CDA-95-2008-01</td>
<td>U.S. government</td>
<td>Settled Dec 1996</td>
</tr>
<tr>
<td>USA-97-2008-01</td>
<td>Mexican government</td>
<td>Pending</td>
</tr>
<tr>
<td>MEX</td>
<td>U.S.</td>
<td>Consultations at NAFTA Commission meeting in 1995; discussions continue between governments</td>
</tr>
<tr>
<td>USA</td>
<td>Canada</td>
<td>Consultations requested on October 23, 1996; consultations were held on November 20, 1996</td>
</tr>
<tr>
<td>USA</td>
<td>Canada</td>
<td>On January 19, 1996 consultations were held</td>
</tr>
<tr>
<td>USA</td>
<td>Mexico</td>
<td>On January 18, 1996 consultations were held</td>
</tr>
</tbody>
</table>

cessful in channeling new resources into environmental projects. The following subsections report notable developments in each area.

Environment
The Council on Environmental Cooperation (CEC) established under the NAAEC has devoted almost half of its $10 million annual budget to joint programs to promote, inter alia, sound management of chemicals, cooperation on environmental enforcement and the development of a North American pollutant-release inventory. These programs operate in relative obscurity, and have been overshadowed by public interest in the dispute procedures.

Through April 1997, the CEC received nine submissions detailing complaints about the enforcement of environmental laws and seeking redress under the NAAEC's environmental enforcement mechanism. Four of these cases were terminated because of lack of evidence or because the issue was already being adjudicated in Canadian courts; four cases are currently being reviewed by the secretariat to determine whether to present the case to the CEC council of ministers for action; and one case has advanced to the stage of compiling a factual record of the dispute (which presages the convening of dispute-resolution procedures).

If this process seems clumsy and unwieldy, it is—and by design. Mexico and Canada staunchly resisted the incorporation of new dispute procedures under the side agreements and insisted that the process be long on consultation and short on adjudication. Indeed, the NAAEC dispute-settlement process can drag out for almost two years, compared with the 240 days under which disputes are normally settled under NAFTA Chapter 19.

The NADBank was designed to channel new financial resources to address the burgeoning capital requirements of environmental projects in Mexico and the United States. The NADBank has been capitalized at $3 billion, with $450 million paid in by each country over four years and the rest callable. At least initially, 90 percent of its funds have been earmarked for wastewater, water treatment and solid-waste projects in the U.S.-Mexico border region; the other 10 percent are targeted for community adjustment and investment projects not limited to the border region.

In 1993, a variety of government, business and environmental groups estimated that the cost of needed wastewater treatment facilities alone in the border region could total $3 to $6 billion over 10 years (Hufbauer and Schott 1993, Table A1, p. 167). Through mid-1997, the NADBank has made barely a dent in that demand. The NADBank has reviewed 12 financing proposals that have been certified by the Border Environmental Cooperation Commission as eligible for NADBank loans. Four projects have been approved, involving about $4 million in NADBank financing, but funds have been disbursed for only one of them (a water-treatment plant in Brawley, California). Six other projects are in the pipeline, one found alternative financing, and one project, which sought a grant rather than a loan, was rejected.

Labor
In contrast to the NAAEC that has a mandate to monitor national policies, mitigate disputes and develop initiatives to upgrade environmental infrastructure, the NAALC has focused primarily on oversight and enforcement of national labor laws and practices. Each country has opened a National Administrative Office (NAO), which serves, inter alia, as a clearinghouse for private sector notifications of abusive labor practices in the region. Such petitions can trigger government-to-government consultations on the matter by the respective NAOS, and subsequently can lead to ministerial reviews and the formation of dispute-resolution panels. It has also sponsored four comparative studies of labor market conditions in the NAFTA region.

Through mid-1997, the record of the dispute-settlement process of the NAALC has been mixed. The U.S. NAO has received six submissions regarding alleged denial of freedom of association and other unfair labor practices by specified employers; the Mexican NAO has received one submission. The outcome of these cases bear mention. In two cases, the petitions exposed problems that were rectified by the national labor authorities: In one instance, the Mexican Labor Board recognized the union subject to dispute; in the other, the U.S. Labor Board ordered a company to reinstate with back pay workers who were laid off when a plant was illegally closed. Two U.S. cases were terminated because of insufficient evidence, one case was withdrawn before the NAO review was completed and the two other U.S. cases led to ministerial consultations.

Building on NAFTA
NAFTA was designed not only to expand trade among neighbors in North America, but also to strengthen the ability of North American firms to compete more effec-
tively in both regional and global markets. This is important because, for the foreseeable future, all three countries will run sizable current account deficits (Mexico's deficit should continue to rise in coming years as its economy recovers and attracts more capital imports). Obviously, each country cannot solve its problems primarily by exporting more to its regional partners; rather, each needs both to export and import more to promote competition in its markets and greater efficiency and productivity of its industries and workers.

In that regard, NAFTA is part of the global trade strategy of each country. Only two weeks after the announcement of U.S.-Mexico free-trade talks in June 1990, President Bush launched the Enterprise for the Americas Initiative (EAI). He envisioned the U.S.-Mexico pact as a stepping-stone to a broader hemispheric arrangement that would help promote the type of economic and political reform that was evolving in Mexico. NAFTA expansion was seen as one possible model for such a pact, and an accession clause was included in NAFTA vaguely similar in form to the GATT provisions.

At the Summit of the Americas in Miami in December 1994, the three NAFTA members committed to negotiate a Free-Trade Area of the Americas (FTAA) with the other democratic nations of the Western Hemisphere by the year 2005, and also agreed to open talks with Chile on NAFTA accession. The Chilean negotiations foundered due to the lack of fast-track negotiating authority in the United States, but Canada and Chile signed a bilateral free-trade pact at the end of 1996 (Chile and Mexico concluded a more limited FTA in 1991).

These regional initiatives progressed initially when the Uruguay Round of multilateral trade negotiations was at an impasse due to U.S.-European differences over agricultural reforms. NAFTA provided new ideas and models for several critical GATT accords under negotiation in Geneva and served as an important building block for those multilateral deals. Even the negative aspects of NAFTA, such as the restrictive rules of origin for textiles and apparel, contributed to the GATT deal by lessening U.S. industry opposition to the phaseout of quotas under the Multi-Fiber Arrangement. On balance, NAFTA has complemented and reinforced multilateral efforts to liberalize trade in the GATT and WTO; in most respects, it has set high standards for both trade liberalization and rule-making that should spur complementary action on a global scale.

Lessons from the NAFTA Experience

NAFTA has been in force for only a few short years and many of its key provisions have not been fully implemented. Its effectiveness has been impeded by the severe macroeconomic shock that beset Mexico in late 1994. It has served as a lightning rod for U.S. concerns about labor adjustment and wage suppression, and in so doing has revived latent protectionist pressures in both major political parties (and enshrined protectionism as a central tenet of the new reform party). Yet despite the harried experience of the NAFTA partners during this period, the trade pact has produced tangible results, as documented in this paper.

As the first comprehensive and reciprocal free-trade agreement between developed and developing countries, NAFTA has also illustrated several important aspects of free-trade pacts that should help inform other developing countries in the Western Hemisphere (or the Asia-Pacific region) that have committed to undertake similar arrangements. I conclude with five critical trade-policy lessons derived from the NAFTA experience:

1. **Macro matters most.** Trade agreements create opportunities; they do not guarantee sales. To promote sustained growth and take full advantage of those opportunities, macroeconomic policy must be prudent—at home and in the partner countries.

2. **Trade pacts provide an insurance policy against new protectionism at home and abroad.** They deter abrupt policy reversals and help governments withstand the protectionist demands of their domestic lobbies. Mexico's response to the peso crisis is evidence of this salutary effect.

3. **Free-trade pacts involve asymmetric obligations that fall more heavily on developing than developed country partners.** The benefit for developing countries is that the pact locks in the domestic reforms needed to reinforce growth, and represents a "Good Housekeeping Seal of Approval" for those policies—thus making them more attractive to foreign investors and promoting the transfer of technology and management skills.

4. **Trade pacts are not engines of job creation, but they do support jobs that provide a substantial wage premium over earnings in the non-exporting sector.**

5. **Integration is an iterative process.** Not all issues of importance in bilateral or regional relations are covered ab initio in trade pacts; but as countries become
more integrated, new issues that span domestic and international concerns often are added to the common agenda. Indeed, as the Summit of the Americas process has demonstrated, trade talks can serve as a magnet for attracting support on a wide array of initiatives, including strengthening democracy, combating drug trade and promoting better environmental conditions and labor rights.

**References**


Riner, Deborah and John V. Sweeney (1997). *The Effects of NAFTA on Mexico*. Mexico City: American Chamber of Commerce of Mexico, processed.


**Notes**

1. On a historical cost basis, U.S. FDI totaled $65.5 billion in 1990 while Canadian FDI in the United States stood at $27.7 billion.

2. These data come from the U.S. Department of Commerce and are not strictly comparable with those published by Mexican sources because of different treatment of maquiladora trade.

3. These data reflect FOB/FOB trade as reported by the Banco de Mexico, and include imports by maquiladoras.

4. These figures were compiled by the U.S. Embassy in Mexico; they are lower than the data reported by SECOFI on registered U.S. investments during this period.

5. Data are from Statistics Canada, *Canada's International Investment Position 1993*.

6. Starting in 1994, SECOFI changed from reporting approved FDI (which may or may not be undertaken) to registered FDI. According to Riner and Sweeney (1997), investments are often registered well after they have been made.

7. A summary of the complete results of the AmCham survey is reported in Riner and Sweeney (1997).

8. These figures include trade of in-bond industries, as published by Banco de Mexico (1996, 1997).

9. While Mexico has been the fastest growing supplier of these products to the U.S. market since 1993, the trade of some CBI countries also grew sharply: El Salvador (up 179 percent), Honduras (up 140 percent).

10. The three countries also concluded an agreement on import surges, which to date has received almost no attention.
Comment

NORA LUSTIG

It is a pleasure to comment on Jeff Schott's paper, "NAFTA: An Interim Report." The paper presents a thorough and clear overview of what has happened to trade and investment flows, employment in the United States and trade disputes since NAFTA's implementation. I fully agree with the author that it is premature—and particularly difficult given the Mexican crisis—to make an assessment of the agreement and its impact scarcely three years after it came into effect. Having said that, are there indications that NAFTA is beginning to deliver on its promises of higher trade and investment flows, gains in efficiency and improved living standards (particularly in Mexico)? Have the costs in terms of employment losses matched the fears of the opponents of NAFTA in the United States? Has NAFTA become the anticipated stepping-stone for global freer trade and regional economic integration?

Strictly speaking, in order to answer some of these questions we would need either an econometric or a computable general equilibrium model to be able to isolate the effects of simultaneous events. After all, the implementation of NAFTA practically coincided with a 45 percent real devaluation of the peso, a 7 percent drop in Mexican output, and a 22 percent fall in Mexican real wages during 1995. There have also been large variations in the value of the U.S. dollar vis-à-vis other major currencies. It is surprising that despite the large number of models that proliferated before NAFTA was approved, there are no readily available estimates on the impact of the various effects so far (at least I have not run across any). In the absence of quantitative studies, we must circumscribe our analysis to, as Schott puts it, "what has happened since NAFTA entered into force rather than what has happened because of the trade pact."

Trade Flows
As discussed by the author, there can hardly be any doubt that since NAFTA's passage, trade among the three signatory countries has been expanding to record levels. For example, during 1994 (NAFTA's first year), trade between the NAFTA countries grew 17 percent, reaching a record of US$350 billion, of which about US$100 billion represents U.S.-Mexico trade. Taking a longer perspective, all of U.S.-Mexico trade surged from US$30 billion in 1986 (a year after Mexico began its trade liberalization and when it joined GATT) to close to US$150 billion in 1996.1

In 1995 NAFTA appears to have contributed to the preservation and promotion of trade, despite Mexico’s crisis. As Schott notes, in contrast with the crisis in 1982, when Mexico reintroduced import permits for most products, this time it kept its open-economy policies largely in place. This might have to do more with Mexico’s unilateral trade liberalization and GATT-membership than with NAFTA. However, given the large weight of imports from the United States in Mexico’s total imports, NAFTA essentially has severely limited the use of protectionist measures to reduce the trade gap. This might partially explain why imports fell by 12 percent during the 1995

Nora Lustig was a Senior Fellow at the Brookings Institution. She now is a Senior Adviser and Chief of the Poverty and Inequality Advisory Unit at the Inter-American Development Bank.
recession, while they contracted by almost 35 percent during the previous recession in 1983.

Notably, during 1995, U.S. (and to a lesser extent Canadian) exports to Mexico were much less affected than those from other areas. While exports from the United States fell by less than 2 percent (and from Canada by 15 percent), exports from Central America declined by 44 percent, from South America by 32 percent, from the European Union by about 26 percent and from Asia by 23 percent. How much of this is related to NAFTA? Part of the difference in export performance might be attributed to the depreciation of the dollar vis-à-vis other major currencies in 1995. However, part of the difference must also be ascribed to the expanded market access for U.S. exporters and the importance of intra-industry bilateral trade between Mexico and the United States, both strengthened by NAFTA.

There is, nonetheless, one worrisome aspect. In 1995, Mexican tariffs were increased to their GATT-bound levels in a handful of economic sectors. Because of NAFTA, the United States—as well as other countries that had signed free trade accords with Mexico—was spared this tariff increase. The question remains to what extent these changes in trade protection are also responsible for the striking differences observed in imports into Mexico. The fact that NAFTA appears to have shielded U.S., and to a lesser extent Canadian, exports from the brunt of the Mexican crisis and the increase in some tariff lines that followed is good news for Mexico's NAFTA partners and provides pro-NAFTA officials and lawmakers with ammunition to defend it. However, it does raise some concerns about NAFTA's impact on trade diversion. Perhaps under the prevailing rules at the time of its implementation NAFTA could be shown to create more trade than it diverted. However, this might not be the case if one factors in the fact that trade barriers against non-members may be raised while NAFTA rules remain intact when circumstances change—as happened, for example, during the Mexican peso crisis in 1995. Worse still, to what extent is trade protection against non-member countries higher precisely because NAFTA restricts the application of higher barriers toward the NAFTA partners? In order to gauge whether NAFTA is really consistent with freer trade on a global scale, it would be useful to monitor and estimate the impact of changes in trade barriers in member countries vis-à-vis non-members.

**Mexico's Economic Performance**

As Jeff Schott points out, NAFTA was not a cause of the Mexican peso crisis. (I find some discrepancies in the author's analysis of what caused it, but this may not be the place to discuss them.) On the other hand, NAFTA appears to be contributing to Mexico's recovery. The Mexican recovery got under way in the third quarter of 1995, and the 7 percent decline in GDP that year was followed by a 5.1 percent growth in output during 1996 (and a similar growth rate is expected in 1997). As the author noted, exports have been the engine of Mexico's recovery. But here again, it is hard to disentangle NAFTA's contribution from Mexico's economic reforms, the devaluation of the peso, and the 1995 recession.

NAFTA's contribution may be more patent in the performance of foreign direct investment. On average, between 1994 and 1996 foreign direct investment (FDI) was almost double (close to US$8 billion) what it was in the three years before NAFTA's implementation. Moreover, in 1995, when portfolio flows became highly negative, FDI was 75 percent above the level in the three years before NAFTA. A comparison with the previous crisis may be telling. During 1983, FDI fell to one-fifth of what it had been in the previous years. Clearly, the business opportunities brought by NAFTA have had a positive impact on FDI decisions, the peso crisis notwithstanding.

**Employment and Wages**

As Schott points out, the gross disemployment effects due to NAFTA are probably negligible. Furthermore, an accurate assessment of the net employment effect of NAFTA would need to look at job creation as well. A recent study that attempts to do this analytically found that the overall impact of NAFTA tariff liberalization on U.S. employment has been slightly positive.3

A more relevant measure of NAFTA-related hardship for American workers may be its effect on wages, particularly for less-skilled workers. Protectionism in the United States is fueled by the widely held perception that free trade hurts U.S. wages, particularly unskilled wages. There is no doubt that real wages for men in the bottom 20 percent of the wage distribution fell and wage inequality rose, particularly during the 1980s. The question is how much of this trend is attributable to freer trade with developing countries, and with Mexico in particular. Though NAFTA's actual effect on wages has not been estimated,
the impact of trade on U.S. wages has been studied extensively. The majority of these studies conclude that international trade explains a relatively small share—about 10 percent—of the observed rising wage inequality and downward trend in real wages of less-skilled U.S. workers.\textsuperscript{4} Other studies find the impact to be higher.\textsuperscript{5} In general, though, most studies suggest that technological change—with its bias in favor of high-skilled labor—is the main factor behind the observed trends.

Even if trade explains a small fraction of the rise in wage inequality and deterioration of less-skilled workers' wages, it is not a negligible one. Protectionism thus becomes an instrument that can produce tangible benefits, even if it is at the expense of higher future growth, and savvy politicians know that well. For those who do not share in the benefits of higher growth, forgoing higher incomes today makes no sense. That is why identifying ways to address the rising economic polarization and declining living standards for the less-skilled deserves greater attention on the part of policymakers. Otherwise, many lawmakers and politicians are likely to continue focusing on the wrong instrument—that is, trade protection—to combat that issue. Likewise, the insistence to include labor standards as part of trade agreements will stick. As is true elsewhere in the region, the United States will have to make a major effort to upgrade the education and skills of the less privileged sectors of the working population. This might be a solution, but not in the short-run. In the short-run other mechanisms to compensate the losers must be implemented.

**Labor and Environment**

The NAFTA side agreements on labor and environment were introduced to gain votes in the U.S. Congress at the time of NAFTA's approval. They imply obligations for signatory countries to enforce their own laws. However, organized labor, many Democrats in Congress and some environmentalists were not satisfied because, in their words, the agreements lack teeth—that is, there were no real provisions to use trade sanctions against violators of the side accords.

The lack of provisions to use trade sanctions within the agreements is a blessing. Otherwise, environmental and labor issues could have been used frequently as excuses to introduce protectionist barriers and thereby obstruct NAFTA's implementation. Still, more could and should be done, on both the labor and environmental fronts, by the governments and NAFTA-created institutions. One repeated concern expressed by U.S. labor leaders is that, given the characteristics of Mexico's political system and the corporatist role played by the official unions, Mexican workers still find it hard to form and belong to independent unions. This appears to have been the case in several of the complaints brought before the U.S. National Administrative Office (NAO). But the recommendations of NAO have been overcautious with this kind of labor-rights violations.\textsuperscript{6} Even if NAO's formal recommendations on these matters are not the equivalent of rulings and do not lead to sanctions under the current terms of the side agreement (such as fines imposed on the country where the violations occurred), greater exposure of such violations could eventually lead to a reduction in them.

On the environmental front, the North American Development Bank (NADBank) could become an effective tool to foster environmental protection and cleanup, especially along the U.S.-Mexico border. The bank's capital will soon reach US$2.25 billion. However, as Jeff Schott notes, since its establishment the NADBank has approved only a handful of NADBank loans that together total less than US$5 million. One factor behind this low level of activity is that the established procedure, in which projects are certified by a commission (the Border Environment Cooperation Commission) before they are analyzed for their financial viability by NADBank, may be flawed. Switching the order in which projects are analyzed and approved may expedite loans.

Another fundamental reason for this low level of lending is that the NADBank's charter constrains it to operate on strictly commercial terms. Many of the potential borrowers, particularly in Mexico, lack the administrative experience and the ability to borrow funds or are simply ineligible. Projects with high social payoffs, thus, will need some form of subsidization, such as governmental nonrefundable grants or private donations. Furthermore, NADBank may eventually need a window of credit on concessional terms for the poorest and most vulnerable communities. Its portfolio of eligible projects should be expanded eventually to include housing, education and poverty reduction projects more generally and find ways to cofinance such projects with the other multilateral development banks.

**NAFTA and Open Regionalism**

Essentially, for an agreement to be consistent with the concept of "open regionalism," at least two conditions have to
be fulfilled. First, trade barriers against non-member countries should not be higher that those existing before the agreement. Second, non-member countries that are willing to abide by the agreement’s rules should be accepted. How is NAFTA performing on those two counts?

In a previous study, Jeff Schott, in conjunction with Gary Hufbauer, argued that NAFTA rules of origin implied a higher level of protection with autos and with textiles and apparel. It is important to assess the impact of these higher restrictions on non-member countries. In the case of textiles and apparel, according to Jeff Schott, the losers seem to be in Asia. However, the impact on the Caribbean Basin Initiative countries appears to be less clear. But this is not what we hear from the governments in Central America and the Caribbean, and a more complete quantification of the impact of NAFTA provisions on this region—including its impact on FDI—is in order. Likewise, the already mentioned changes in trade policy introduced after NAFTA came into effect (such as the increase in tariffs observed in Mexico) should be monitored and their impact on non-member countries carefully assessed.

In terms of allowing new countries to become members, NAFTA’s track-record so far is—to put it mildly—rather poor. The most striking example is the non-incorporation of Chile, a country that has repeatedly manifested its readiness to join NAFTA. The stumbling block is the United States, because the administration has shied away from presenting the request for fast-track authority to Congress. Hence, the possibility of serious negotiations has been postponed at best.

A combination of protectionist forces in both parties, together with the administration’s fear of alienating the Democrats who are pushing for the inclusion of environmental and labor standards in the expansion of NAFTA (or, for that matter, in any subsequent free-trade agreements), has impeded moving forward. The Mexican crisis, with its consequential fall in U.S. exports to Mexico and the need for a U.S.-led financial rescue package, undoubtedly made selling NAFTA expansion a politically difficult task. Whatever the reasons, the fact of the matter is that NAFTA has not been an “open” agreement in this respect.

To turn NAFTA into a genuine building block for global free trade, the three member countries should continue reducing their tariff structure for most-favored-nation status, should not raise trade barriers against non-members and should move toward a common external tariff to eliminate the conundrum and potential hidden protection found in the rules of origin. They should also accept the incorporation of willing new members such as Chile into NAFTA.

The political resistance in the United States to NAFTA expansion or NAFTA-like agreements reveals some weak links in the economic integration agenda. Three main issues require more attention. First, there is the issue of the social costs caused by greater integration and the need to find adequate mechanisms to compensate the losers and make the process a socially inclusive one. Second, countries should explore how much macroeconomic consultation and coordination is feasible and desirable so they can avoid wide exchange-rate movements and sharp crises. Finally, we are in need of recommendations of how, if at all, labor and environmental issues should be incorporated into the discussion and implementation of trading agreements.

Notes

1. These are Mexican figures and are different from those presented by Schott. U.S. and Mexican figures differ primarily because of the treatment of maquiladoras.


3. Hinojosa Ojeda, Raul and others (1996), North American Integration Three Years After NAFTA: A Framework for Tracking, Modeling and Internet Accessing the National and Regional Labor Market Impacts (University of California, Los Angeles, School of Public Policy and Social Research, December).


6. Lawrence, op. cit.

7. More recently, Central American and Caribbean countries changed their stance from requesting NAFTA-parity to requesting that they become NAFTA members (or, alternatively, that they sign a NAFTA-type agreement with the United States), but the United States has not agreed to move forward so far.
V. Mercosur
Mercosur: Objectives and Achievements

S A M L A I R D

The Southern Common Market (Mercado Común del Sur, or Mercosur) is a notable example of renewed worldwide interest in regional trade agreements, although these agreements have provoked concerns about the possibility of welfare-reducing trade diversion as well as their systemic implications for world trade.

Concern about the possible trade-diverting effects of Mercosur (and other Latin American regional integration agreements) stems mainly from the experience of earlier attempts at regional integration. In the 1960s the regional agreements were an extension of the import-substitution industrialization policies being applied in the individual countries under the influence of Raúl Prebisch and United Nations Economic Commission for Latin America and the Caribbean (ECLAC). In reviewing the efforts in the 1960s to establish the Latin American Free Trade Association (LAFTA), the Andean Pact and Central American Common Market (CACM), de Melo and Dhar (1992) argue that there were several reasons for failure: First, reductions were not across the board but on a product-by-product basis that resulted in many exceptions; second, high rates of protection were maintained against third countries; and third, there was little scope for efficiency gains through the exploitation of economies of scale. Langhammer and Hiemenz (1991) reached a similar conclusion.

Today, the context is very different. In conjunction with macroeconomic (and political) reforms pursued in the aftermath of the debt crisis of the early 1980s, there has been serious import liberalization in most Latin American countries. Edwards (1994), Laird (1995) and Rajapatirana (1994) show that throughout Latin America tariffs have been substantially reduced and rationalized and there has been a substantial reduction in the use of non-tariff measures. For example, prior to these reforms Argentina had a tariff average of some 30 percent in 1989, Brazil’s rate was 51 percent in 1988 and Uruguay’s was more than 100 percent in 1978 (GATT 1992a, b and c). These rates were reduced in unilateral reforms up to 1991 when the Treaty of Asunció was ratified, and then continued to be reduced as part of the process of convergence toward Mercosur. By the time of implementation of the Common External Tariff (CET) in 1995, external tariffs among members averaged some 10.7 percent. Thus, the new interest in regional agreements takes place against a backdrop of increased outward orientation, exhibited in unilateral reforms as well as increased membership and substantive participation in the work of the General Agreement on Tariffs and Trade (GATT) and now the World Trade Organization (WTO).

Sam Laird is at the World Trade Organization in Geneva. Helpful comments were received from Isidoro Hodara, Homi Kharas, Petros Mavroidis, Dermot McAleese, Paul Meo, Manuel Olarreaga, Marcelo Olarreaga, Sheila Page, Dimitris Papageorgiou, Sarath Rajapatirana, Esteban Ropelo, Malcolm Rowat, Raymundo Valdés, Jorge Vigano and Alan Winters. Thanks are due to Gérard Durand for assistance with the tariff data.
There is little question that intra-Mercosur trade has grown rapidly during the period from the signing of the Treaty of Asunción up to the establishment of the common external tariff at the beginning of 1995. Table 1 shows that exports within Mercosur have more than doubled as a share of total exports since 1990, while imports from within the group have also expanded sharply as a share of the total. However, the growth of intra-Mercosur trade cannot be attributed uniquely to trade diversion resulting from the creation of Mercosur because, apart from certain years and partners, trade also has been growing strongly with other countries in the same period. Moreover, one of the more important and fastest growing areas of trade in Mercosur is the automotive trade between Argentina and Brazil under arrangements that are not yet part of Mercosur per se, but are among the exceptions (more later). In addition, in 1995 imports from outside the region grew faster than intra-regional trade.

The Objectives and Achievements of Mercosur

Establishment of Mercosur

Mercosur was established under the Treaty of Asunción, signed on March 26, 1991, by the presidents of Argentina, Brazil, Paraguay and Uruguay. The treaty was subsequently ratified by all members and entered into force on November 29, 1991. The Treaty of Asunción has been formally amended once, in the Additional Protocol of the Treaty of Asunción, known as the “Protocol of Ouro Preto,” signed on December 17, 1994. This protocol, which concerns mainly institutional issues as well as dispute-settlement, also confers on Mercosur a distinct international legal personality.

The Treaty of Asunción foreshadowed the establishment of a common market among the four countries with free circulation of goods, services, capital and workers starting on January 1, 1995 (but not all of this ambitious program was achieved, as discussed later). The treaty has 25 articles in six main chapters covering the purposes, principles and instruments of Mercosur, the organizational structure, the period of application, accession, denunciation (withdrawal) and general provisions. In addition, there are annexes covering the trade liberalization program, rules of origin, dispute-settlement, safeguards (including safeguards against other members of Mercosur), and the establishment of technical and policy working groups. Safeguards follow the guidelines of Article XIX of the GATT, but these have not been allowed on intra-regional trade since the beginning of 1995. The treaty set out the broad principles for dispute-settlement, and various stages and procedures were elaborated in the Brasilia Protocol for the Settlement of Disputes, signed on December 17, 1991; this is maintained in

TABLE I
External Trade of Mercosur 1985–94
(U.S. millions of dollars and percent)

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<td><strong>EXPORTS</strong></td>
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<tr>
<td>World (US$ m.)</td>
<td>30,549</td>
<td>34,133</td>
<td>44,875</td>
<td>46,550</td>
<td>46,403</td>
<td>45,896</td>
<td>50,467</td>
<td>54,122</td>
<td>61,893</td>
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<tr>
<td>Intra-Mercosur</td>
<td>8.6</td>
<td>7.4</td>
<td>6.6</td>
<td>8.2</td>
<td>8.9</td>
<td>11.1</td>
<td>14.3</td>
<td>18.3</td>
<td>19.5</td>
<td>20.5</td>
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<tr>
<td>Total extra-Mercosur</td>
<td>91.4</td>
<td>92.6</td>
<td>93.4</td>
<td>91.8</td>
<td>91.1</td>
<td>88.9</td>
<td>85.7</td>
<td>81.3</td>
<td>80.5</td>
<td>79.5</td>
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<tr>
<td>Other LAIA</td>
<td>7.8</td>
<td>6.8</td>
<td>7.0</td>
<td>7.2</td>
<td>7.1</td>
<td>9.1</td>
<td>10.3</td>
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<tr>
<td>USA</td>
<td>21.7</td>
<td>24.3</td>
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<td>19.7</td>
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<td>EEC 15</td>
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<td>29.9</td>
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<td>30.3</td>
<td>26.7</td>
<td>27.0</td>
<td>23.5</td>
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<tr>
<td>Japan</td>
<td>6.2</td>
<td>5.4</td>
<td>3.9</td>
<td>5.8</td>
<td>6.0</td>
<td>6.6</td>
<td>5.4</td>
<td>5.2</td>
<td>4.9</td>
<td>3.1</td>
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<tr>
<td>Rest of World</td>
<td>28.3</td>
<td>28.5</td>
<td>28.8</td>
<td>29.6</td>
<td>25.6</td>
<td>25.9</td>
<td>22.4</td>
<td>21.8</td>
<td>21.2</td>
<td>24.0</td>
</tr>
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</table>

| **IMPORTS** |      |      |      |      |      |      |      |      |      |      |
| World (US$ m.) | 21,726 | 24,133 | 23,126 | 26,056 | 29,298 | 34,264 | 40,632 | 48,082 | 62,218 | 79,839 |
| Intra-Mercosur | 12.3 | 10.8 | 13.2 | 15.1 | 14.5 | 15.3 | 18.4 | 19.6 | 19.9 | 18.1 |
| Total extra-Mercosur | 87.7 | 89.2 | 86.8 | 84.9 | 85.3 | 84.7 | 81.6 | 80.4 | 80.1 | 81.9 |
| Other LAIA | 7.2  | 7.6  | 6.4  | 7.1  | 6.9  | 7.2  | 7.1  | 5.9  | 5.7  | 6.1  |
| USA | 20.3 | 18.4 | 18.5 | 19.9 | 19.2 | 21.2 | 22.1 | 22.0 | 22.0 | 22.1 |
| EEC 15 | 25.0 | 25.8 | 24.7 | 22.5 | 22.2 | 23.1 | 23.6 | 23.9 | 27.4 | 27.5 |
| Japan | 6.7  | 6.3  | 6.9  | 7.0  | 7.0  | 6.4  | 5.5  | 5.5  | 4.6  | 4.7  |
| Rest of World | 28.5 | 31.1 | 30.3 | 28.4 | 30.2 | 26.8 | 23.2 | 23.1 | 20.4 | 21.5 |

Source: UNSTAT Comtrade Database.
accordance with Article 43 of the Protocol of Ouro Preto.

Brazil notified the GATT of the Treaty of Asunci6n on February 18, 1992, on behalf of the Secretariat of the Latin American Integration Association (LAIA).3 The notification was made under the provisions of the Enabling Clause, rather than Article XXIV, which contains the main provisions concerning territorial application, frontier traffic, customs unions and free-trade areas. The Enabling Clause, formally known as the Tokyo Round Decision on “differential and more favorable treatment, reciprocity and fuller participation of developing countries,” includes a legal cover for preferential-trade agreements between developing countries, subject to certain conditions, including transparency. The essential provisions are that any such arrangement should not raise barriers or create undue difficulties for other contracting parties (i.e., countries or trading entities that are signatories to the GATT); that no criteria are specified for judging the acceptable degree of mutual reduction or elimination of tariffs;4 and that the reduction of non-tariff measures (NTMs) are to be governed by “criteria which may be prescribed by the Contracting Parties” (Paragraph 2(c)). On the other hand, unlike Article XXIV, there is no specification that substantially all trade is to be covered, but already some 95 percent of intra-regional trade was duty-free by the end of 1994 (WTO 1996b, p. 25).

The only significant change in procedures for examining a regional trade agreement resulting from the creation of the WTO stems from the requirement of the Agreement on Rules of Origin that a detailed work program for the future be established. However, within the WTO, the relevant working party of the Committee on Trade and Development, which was established to examine the GATT/WTO consistency of the treaty, did not complete its work, and the agreement is now being examined by the Committee on Regional Trade Agreements, established in February 1996, in the light of the provisions of GATT 1994, including Article XXIV.5

Institutional Structure
Under Article 1 of the Protocol of Ouro Preto, the institutional structure of Mercosur was established as follows:

(i) the Council of the Common Market (consisting of Ministers of Foreign Affairs and Ministers of Economy);
(ii) the Common Market Group;
(iii) the Mercosur Trade Commission;
(iv) the Joint Parliamentary Commission;
(v) the Economic and Social Consultative Forum; and
(vi) the Mercosur Administrative Secretariat.

The role and composition of these bodies, of which the first three (the decisionmaking bodies) are given in hierarchical order, are laid out in the Protocol. The Ministeriallevel Council embodies the legal entity of Mercosur and is empowered to negotiate and sign agreements on behalf of Mercosur with third countries and international organizations. Oversight of the management of Mercosur is assured by meetings of the Common Market Group, the main executive body, every three months. It comprises senior officials (four representatives and four alternates from each country) who must include representatives of the Ministries of Foreign Affairs, the Ministries of Economy (or equivalent) and the Central Banks. Meetings of Ministers of Economy and Central Bank Governors constitute the institutional framework for the exchange and analysis of macroeconomic policies.

The Trade Commission has a number of technical working committees and is responsible for coordinating common trade policy and implementing the common external tariff. The Joint Parliamentary Commission and the Economic and Social Consultative Forum are both consultative bodies. The Administrative Secretariat, which is quite small and based in Montevideo, is to provide operational support for Mercosur, but it is not intended to be a strong policy- or rule-making supranational authority along the lines of the European Commission.6

Essentially, Mercosur is an international treaty subscribed by the member states, and the bodies established under the treaty are inter-governmental, rather than supranational. Below the level of the treaty, implementing decisions, resolutions and directives (in order of importance) are determined, respectively, at the level of the council, the Common Market Group and the Trade Commission, but have no force by themselves and need to be implemented by corresponding national measures.7 Unlike the Council of Ministers or the Commission of the European Communities, the Mercosur common bodies do not have powers to oblige a member state to comply with common market rules.

There is no supranational court through which either a member state or the Secretariat can enforce treaty obligations on another member or a private party. There is provision for arbitration under the Brasilia Protocol (1991), but
trade disputes are typically resolved by negotiation. By the beginning of 1997 only one dispute had been sent to a specially constituted tribunal or expert panel under the Brasilia Protocol, and this was settled bilaterally (i.e., "out of court") in early April 1997.\textsuperscript{8} It is clear that the authorities are still moving forward cautiously in this area.

The Common Market Group has two committees (on rules—\textit{normalización}—and sanitary and phytosanitary measures). It is also advised by a number of working groups, or "subgroups," which examine certain issues relating to the integration process. Up to 1995, sub-groups worked under the following broad headings: trade issues; customs issues; technical standards; fiscal and monetary matters related to trade, inland transport; maritime transport; industrial and technological policy; agricultural policy; energy; coordination of macroeconomic policies; and labor policy. These sub-groups carry out programmed examination of issues on which they make recommendations to the Common Market Group for consideration and implementation (see GATT 1994). In 1995, under Resolution No. 20/95, a new structure was established, consisting of 10 subgroups:

- Subgroup 1: Communications;
- Subgroup 2: Mining;
- Subgroup 3: Technical Rules;
- Subgroup 4: Financial Matters;
- Subgroup 5: Transport and Infrastructure;
- Subgroup 6: Environment;
- Subgroup 7: Industry;
- Subgroup 8: Agriculture;
- Subgroup 9: Energy;
- Subgroup 10: Labor and Social Security.

A new Subgroup 11 (Health) was created by the Common Market Council at a meeting in Fortaleza in December 1966. There are also specialized meetings on science and technology and tourism, as well as ad hoc groups on services, institutional matters, Mercosur-LAIA, Mercosur-WTO and sugar.

The Mercosur Trade Commission is advised by a Committee on the Defense of Competition as well as 10 Technical Committees: (i) Tariffs, Nomenclature and the Classification of Goods; (ii) Customs Matters; (iii) Rules and Trade Disciplines; (iv) Public Policies that Distort Competitiveness; (v) Defense of Competition; (vi) Unfair Practices and Safeguards; (vii) Consumer Protection; (viii) Non-Tariff Restrictions and Measures; (ix) the Automotive Sector; and (x) the Textile Sector.

Overall, the various commissions and committees have carried out an impressive amount of work, but the weakness in the central institutional structure appears to constitute a particular disadvantage for the smaller members, leaving them vulnerable to political pressures. Moreover, Bouzas (1996) has observed that, while skepticism toward supranational agencies is comprehensible in the light of earlier experience in Latin America, several issues, such as investment and services (discussed further below), need to be handled at a supranational level if the union is to advance and be deepened.

\textbf{Border Measures and Procedures}

Article 5 of the treaty sets out the agreed liberalization program, which was to consist of "progressive, linear and automatic tariff reductions accompanied across the board by the elimination of non-tariff restrictions or equivalent measures...with a view to arriving at a zero tariff and no non-tariff restrictions for the entire tariff area by 31 December 1994." After an initial tariff reduction of 47 percent in applied rates that followed the ratification of the Treaty of Asunción in 1991, individual states generally realigned tariffs on schedule every six months in equal stages up to the implementation of the Common External Tariff (CET) at the beginning of 1995 (except where increases were implied).

The CET is applied to imports from partners subject to most-favored-nation (MFN) rates. Whereas only the broadest structure was set in 1991 (in order to determine the extent of the scheduled cuts), finalization was the subject of intense internal negotiations that were concluded in late 1994. It was then implemented, with exception lists for each Mercosur member, on January 1, 1995. The CET, based on the Harmonized Commodity Classification and Coding System (HS), consists entirely of ad valorem rates, charged on the CIF (cost, insurance and freight) value of the imports. Table 2 gives an overview of the structure in 1995, by main sections of the International Standard Industrial Classification (ISIC), together with the rates to be applied when the exceptions are eliminated by the end of the transition periods (up to 2001 for Argentina and Brazil and up to 2006 for Paraguay and Uruguay).

The scheduled MFN rates, which individual members apply as exceptions to the CET in the transition period, include sensitive items, and are intended to facilitate structural adjustment, helping to place the sectors involved in a
competitive position within the region at the end of the period in question; negotiations are also being conducted "with a view to harmonizing public policy in various areas and establishing a trade regime that will ensure fair competition" (WTO 1995a). Thus, while the CET for capital goods has been set at 14 percent, Argentine and Brazilian tariffs for these products are allowed to converge to that rate in a linear and automatic manner over the period to January 2001, while Uruguay and Paraguay have until January 2006 to achieve convergence. For telecommunications and information technology equipment the CET is fixed at 16 percent with convergence by all members by 2006. Some 1140 eight-digit tariff items are covered by the capital goods exemptions and some 435 in telecommunications and informatics.

Initially, it was agreed that Argentina, Brazil and Uruguay would also have the right to have 300 national exceptions to the CET, while Paraguay would have the right to 359 (WTO 1995a). Items could be eliminated from these lists, but no new items could placed on the lists, creating a ratcheting down effect. These exceptions could be higher or lower than the CET, so that for convergence to the CET, upward and downward modifications to national tariffs of the four members are required. For example, in 1995 the Mercosur countries reported to the WTO that Argentina, Brazil, Paraguay and Uruguay would increase the rates on 84, 123, 214 and 212 items in the Mercosur common tariff schedule, respectively, while decreasing the rates on 147, 52, 0 and 6, respectively (WTO 1995a).

Apart from these items where the national scheduled rates diverge from the CET, each member has its own list of special concessionary regimes where rates may be reduced below scheduled rates—e.g., on investment items, to assure basic supplies of primary products and inputs for other industries, temporary admission of goods to be re-exported, to allow duty-free entry of goods from the free zones of Manaus and Tierra del Fuego, and so on. These regimes are to be consolidated into a common set of Mercosur regimes to replace the national concessions, but a timetable has yet to be determined.

Mercosur countries maintain that the CET has been fixed in conformity with Paragraph 5 of Article XXIV of the GATT, which requires that "the duties...in respect of trade with [non members]...shall not on the whole be higher than...the duties...prior to the formation of [the] union." Elaborating on this, the Understanding on the Interpretation of Article XXIV of the GATT 1994 states that "the general incidence of the duties and other regulations of commerce applicable before and after the formation of a customs union shall in respect of duties and charges be based upon an overall assessment of weighted average tariff rates and of customs duties collected." Prima facie, the CET would seem to meet the test of the GATT: Thus, although Paraguay's average tariff was lower than under Mercosur, its weight in trade was quite small, while the large members previously had higher average rates. Thus, when the Treaty of Asunción was signed at the end of 1991, Argentina's average rate was 12.2 percent and Uruguay had a 21.5 percent global rate, while Brazil's rate was 21.2 percent in January 1992 (GATT 1992a, b and c). However, these are simple average MFN rates, and they do not take account of concessional entry.

It is important to note that the applied tariff levels, as shown in Table 2, are considerably lower than the levels that are legally bound in the WTO. Thus the tariff bindings, made by the individual Mercosur countries (not the CET on behalf of the customs union, unlike the EU's CET), are mostly at a ceiling level of 35 percent, with the main exceptions being tarifed agricultural import barriers. These are allowed to be implemented over 10 years, although Argentina implemented these rates fully in 1995. The gap between the applied and bound rates provides a wide margin for tariff increases without having to renegotiate concessions under Article XXVIII of the GATT, and must inevitably lead to some uncertainty in the tariff regime. The fact that Brazil, in June 1995, increased tariffs to 70 percent for a number of products (in addition to introducing quotas on automotive imports) confirms this sense of uncertainty, albeit within the binding commitment for 1995 (to be reduced progressively over 10 years to 35 percent). However, security of access to Mercosur was improved by the substantial extension of the coverage of the tariff bindings to all trade, compared with a situation prior to the round where binding coverage was only 4 percent of items in the case of Argentina and Uruguay and 6 percent for Brazil. Mercosur's CET is characterized by tariff escalation: Tariff protection for raw materials (first stage of processing) was on average 6.3 percent in 1995, 9.1 percent for semi-manufactures and goods used as inputs for other production chains, and 12.5 percent for fully processed goods (see Table 3). Escalation was most marked in Brazil and least pro-
### Table 2

**Mercosur Tariff Structure, 1995 and Final CET (2001 or 2006)** (percent)

<table>
<thead>
<tr>
<th>ISIC CODE</th>
<th>PRODUCT AND PROCESSING DESCRIPTION</th>
<th>ARGENTINA</th>
<th>BRAZIL</th>
<th>PARAGUAY</th>
<th>URUGUAY</th>
<th>AVERAGE</th>
<th>FINAL</th>
</tr>
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<td>Agriculture, hunting, forestry &amp; fishing</td>
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<td>7.0</td>
<td>6.9</td>
<td>6.9</td>
<td>7.0</td>
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<td>Agricultural and livestock production</td>
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<td>6.8</td>
<td>6.8</td>
<td>6.9</td>
<td>7.0</td>
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<tr>
<td>12</td>
<td>Forestry and logging</td>
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<td>4.7</td>
<td>4.4</td>
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<td>4.6</td>
<td>4.6</td>
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<td>2.0</td>
<td>2.0</td>
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<td>8.7</td>
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<td>8.7</td>
<td>8.7</td>
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<td>Rubber products</td>
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Note: CET to be completed by Argentina and Brazil by 2001 and by Paraguay and Uruguay by 2006.
Source: WTO Secretariat calculations, based on data supplied by Mercosur.
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<tr>
<th>ISIC CODE</th>
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<th>ARGENTINA</th>
<th>BRAZIL</th>
<th>PARAGUAY</th>
<th>URUGUAY</th>
<th>AVERAGE</th>
<th>FINAL</th>
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nounced in Paraguay in 1995 (the first three lines of Table 3). For the CET as it will be applied after full implementation, escalation will be on average slightly more pronounced than in 1995. Tariff escalation exists in practically all sectors, with petroleum refineries being the sole exception.

The presence of tariff escalation means that processing industries benefit from higher levels of protection on their value-added than is evident from the nominal tariffs alone. An indication of the levels of effective tariff protection may be obtained from a special study carried out in Brazil (Kume 1996), showing the current level of tariff protection, as well as the level that is expected to prevail following full implementation of the CET in 2001 or 2006 (see Table 4). This latter rate is therefore representative of the effective protection that will be available throughout Mercosur.

The highest effective protection is accorded to passenger cars, trucks and buses, reflecting higher nominal tariffs on motor vehicles and the relatively low value added in the

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**TABLE 3 (CONTINUED)**

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*Note: CET to be completed by Argentina and Brazil by 2001 and by Paraguay and Uruguay by 2006.*

*Source: WTO Secretariat calculations based on data supplied by Mercosur.*
TABLE 4
Effective Rates of Protection by Activity in Brazil, 1993–2006
(percent)

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<td>23.2</td>
<td>20.8</td>
<td>14.3</td>
</tr>
<tr>
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<td>26.3</td>
<td>51.3</td>
<td>20.4</td>
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<td>Electronic equipment</td>
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<td>21.3</td>
<td>24.9</td>
<td>13.0</td>
</tr>
<tr>
<td>Cars, trucks, buses</td>
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<td>44.6</td>
<td>270.9</td>
<td>53.1</td>
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<tr>
<td>Other vehicles and parts</td>
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<td>21.6</td>
<td>21.0</td>
<td>14.4</td>
</tr>
<tr>
<td>Wood and furniture</td>
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<td>9.4</td>
<td>12.3</td>
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<tr>
<td>Cellulose, paper, etc.</td>
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<td>8.0</td>
<td>10.5</td>
<td>12.6</td>
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<tr>
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<td>15.3</td>
<td>14.6</td>
<td>14.7</td>
</tr>
<tr>
<td>Chemicals</td>
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<tr>
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<tr>
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<td>2.3</td>
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<td>9.9</td>
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<tr>
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<tr>
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<tr>
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<td>9.3</td>
</tr>
<tr>
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<td>22.2</td>
<td>23.9</td>
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</tr>
<tr>
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<td>Maximum</td>
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industry. Other activities benefiting from higher than average levels of effective protection include electrical materials, electronic equipment, the dairy industry, beverages and food products, textiles and plastic products. In contrast, activities with effective rates considerably below the average, notably non-fuel mining, agriculture and chemicals, tend to be relatively disadvantaged by the tariff structure; the negative effective protection estimated for petroleum and coal mining indicates that these activities are even more disadvantaged by the existing tariff structure.

The CET rates may not be modified without the consent of all Mercosur participants, other than to bring rates on items in the exceptions lists more rapidly into alignment with the CET than scheduled. However, in the transition period modifications are being allowed. Thus, in 1995 Brazil was permitted to exempt from the CET a further list of up to 150 additional items as part of its stabilization program for price-control and domestic-supply considerations. The products mainly covered food items such as meat, cheese, rice and barley, but also covered steel products and consumer durables, including cars, on which rates were increased to 70 percent. In early 1996, the list was reduced and amended, with butter, oil and wine being added to preclude "undesirable" imports (WTO 1996b). Tariffs on textiles were retained at 70 percent and increased on wine from 20 to 35 percent. When the additional list expired in 1996 safeguard measures were introduced on textiles (under the provisions of the WTO Agreement on Textiles and Clothing), and tariffs were increased from 20 percent to 70 percent on toys (under the main WTO safeguards provisions). The same procedure for modifications of the national rate would have provided legal cover for the periodic reintroduction and modification of the Argentine statistical tax (now bound at 3 percent under the WTO in respect of "other duties and charges"); this was used in the past like an import surcharge for fiscal reasons, while preserving the psychologically important nominal anchor of the national currency to the U.S. dollar. The increases in tariffs and charges by Brazil and Argentina were within the overall binding commitments at the time.

It is important to note that there remain a number of exceptions to duty-free treatment on trade within Mercosur. Thus, when the CET was introduced in January 1995, the members also agreed on a Regime of Final Adjustment (Regimen de adecuación) to the Customs Union, which allows exceptions to internal duty-free trade. For items covered by this regime, there are to be tariff reductions on intra-group trade in a linear and automatic manner until a zero rate is reached. For Argentina and Brazil, the reductions began on January 1, 1995, and are to be completed by December 31, 1998; for Paraguay and Uruguay, the reductions began on January 1, 1996, and are to be completed by December 31, 1999. The main list of goods covered is not extensive, and includes sensitive agricultural and industrial products; it is estimated by Mercosur countries as covering some 5 percent of intra-Mercosur trade. However, this does not take account of the exceptions made for sugar or automobiles; the latter is of particular importance in trade between Argentina and Brazil.
Turning to non-tariff restrictions on external trade, a distinction is made between those that have to be eliminated and those that have to be harmonized, such as measures relating to plant and animal health, technical standards, environmental protection and safety. This will also allow for a common Mercosur policy consistent with WTO provisions; Annex II of the Treaty of Asunción reproduces the Resolution of the Common Market Group establishing the regulatory framework for the elimination of non-tariff restrictions and harmonization of measures of a non-tariff nature. Under the trade liberalization program of the Treaty of Asunción (Annex I), non-tariff measures were to be eliminated on internal trade under the LAIA framework (Economic Complementarity Agreement No. 18). However, while a number of non-tariff measures have been eliminated, the elimination of others still requires legislative approval at the national level. (See also discussion of sectoral policies below).

Annex IV of the Treaty for the application of safeguards follows the guidelines laid down in Article XIX of the GATT (Emergency Action on Imports of Particular Products), adapting them to the institutional framework of Mercosur and the "need to protect the situation of certain sectors of domestic industry in some of the States Parties to Mercosur" (GATT 1995a). Common Rules on Unfair Trade Practices by third countries and Common Rules and Safeguard Measures against third countries were agreed under Decision No. 17/96 of the Common Market Council in December 1996. Under the decision, a Trade Defense and Safeguards Committee was also created, taking over the relevant functions of the Trade Committee. It is responsible for safeguards investigations. A safeguard measure may be taken by Mercosur as a group or on behalf of a simple member. National action is no longer envisaged in terms of GATT Article XIX, but this may still be possible under the special safeguards provisions of the WTO Agreement on Textiles and Clothing as well as the Agreement on Agriculture.

Under Article 1 of Annex IV, safeguard actions by one member state against another have not been allowed since the beginning of January 1995. However, anti-dumping actions are still allowed under Resolution No. 129/94 of the Common Market Group until such time as there is agreement on a set of common rules on the defense of internal competition. The Council of the Common Market in Fortaleza, meeting December 16–17, 1996, decided under Decision No. 18/96 to continue this situation until December 31, 2000.

Concerning procedural customs issues, the meeting of the Council and the Common Market Group at Ouro Preto on December 16–17, 1994, adopted a series of decisions and resolutions that, as well as bringing the common external tariff (with the noted exceptions) into effect, included a number of common trade policy measures necessary for its implementation—for example, a common system of rules of origin, regulations against unfair trade practices by third countries, a Mercosur customs code and a series of harmonized customs regulations. However, the customs code was only ratified by Paraguay and is currently being renegotiated. The possibility of integrated customs controls at the internal frontiers has been discussed, but there is no question of their elimination, even after duties and other restrictions on internal trade are eliminated. This is because duties and domestic indirect taxes will be collected by the member state which is the final destination of imports from third countries, while indirect taxes will also be collected in imports from other Mercosur countries.

Administrative difficulties have so far limited the implementation of free circulation of goods. Free circulation would mean that, once imports from third countries enter one Mercosur country, they should be able to cross internal frontiers into other Mercosur countries simply by showing that the duty under the CET has been paid at the first port of entry. Duties collected in the first country would then be transferred to the authorities in the country of final destination on the basis of the paperwork provided by the importer at the port of entry. At present, while free circulation is intended, in practice most goods from third countries for transit through one Mercosur country to another travel under international transit arrangements (i.e., under customs seal) and pay duty only in the final country of destination. (This mainly concerns Paraguay, which is landlocked.) Arrangements for the transfer of receipts of customs duties to the final country of destination still need to be worked out. Thus, shipments that do not enter Mercosur under international transit provisions and that pay the duty at the first port of entry could well encounter problems at the internal frontier if the shipper expects not to have to pay duty at that point.

Apart from the tax and duty arrangements, and despite ongoing efforts to simplify the transit of goods and persons, there are periodic reports of delays at the frontiers.
The work on rules of origin is intended to lead to harmonized rules, since there is no intention of abolishing internal frontiers along the lines of the EU's single market. Customs will determine the origin of goods and, hence, the appropriate level duty to be paid to the fiscal authorities in the country of final destination. Duties on goods from third countries that are processed in one Mercosur country before being re-exported to another will essentially be assessed on the basis of general rules of change of tariff classification and/or 60 percent local content, as well as special rules for the capital goods, chemical, telecommunications and information-technology sectors. Thus, to a large degree the problems that Krueger (1995) identifies in respect of FTAs will not be avoided in Mercosur.

Common Trade Policy
The adoption of a common trade policy toward third countries is considered by the Mercosur countries to be "an inseparable complement to the implementation of a common external tariff" (WTO 1995a), and Mercosur has defined the main elements of such a policy. While the Ouro Preto meeting took a number of decision on trade policy these relate mainly to customs matters, as discussed above, and some sectoral questions, discussed later. They do not refer specifically to trade policy to third countries, although this is now becoming much clearer.

In terms of relations with third countries, Mercosur is also intended to be an open regional agreement. Paraguay, on behalf of the Mercosur countries, has stated that it is "a flexible and open process, the opposite of the idea of a 'fortress' reformulating, at the quadripartite level, old isolationist concepts" (WTO 1995a). This can mean several things. On the one hand, Mercosur may take the form of open regionalism in which liberalization is also applied to third countries. On the other hand, the agreement may also be open to membership or to the exchange of concessions with other countries or regional blocks. To evaluate these possibilities, we look at common external trade policy first in the multilateral context of the WTO, second in the context of the LAIA, and third in respect of bilateral relations with other countries and groups of countries.

First, in the WTO, despite the goal of establishing a common trade policy, the member states of Mercosur continue to be represented individually, compared with the European Union, where the European Commission speaks on behalf of its members. The exception to this is the new Committee on Regional Trade Agreements, where Mercosur is represented by the presidency pro tempore (which changes every six months). As noted earlier, in the Uruguay Round tariff bindings were made individually, not as a Mercosur commitment. To the extent that nationally bound tariffs are currently lower than the CET, members are to engage in a process of renegotiation of tariff bindings to align these rates with the CET. Similarly the processes of eliminating internal exceptions to duty-free trade and convergence to the applied CET will be important steps toward establishing a common external trade policy.

Currently, common trade rules on anti-dumping have been drafted and are being revised to bring them into alignment with WTO rules. In the meantime, members are applying their domestic legislation, keeping the Mercosur Trade Commission informed of any actions. Although no decision has been taken to this effect, when harmonized rules are agreed, it would seem logical that these be implemented through the Trade Defense and Safeguards Committee, as has been agreed for safeguards. Following that practice, measures could then be imposed in respect of any single member or Mercosur as a whole.

Article 50 of the Treaty of Montevideo, in accordance with Article XX (General Exceptions) and Article XXI (Security Exceptions) of the GATT, permits LAIA members, including those within the framework of Mercosur, to apply trade measures for protection of public morality; human, animal and plant life and health; and national security. This also covers regulation of imports and exports of arms, munitions, etc.; imports and exports of gold and silver in bullion form; protection of national treasures of artistic, historical or archaeological value; and the exportation, use and consumption of nuclear materials, radioactive products or any other material used for the development and exploitation of nuclear energy. Details are provided in Annex I to GATT (1994).

In many areas of trade policy, convergence to WTO criteria, while leaving scope for national variations, will facilitate the establishment of a common policy, as well as improving integration within Mercosur. The wide sweep of WTO commitments, compared to the GATT, results from the obligation under the single undertaking of the round of all members of the World Trade Organization to implement all but the four multilateral accords (the Agreement on Trade in Civil Aircraft, the Agreement on Government
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Procurement, the International Dairy Agreement and the International Bovine Meat Agreement. Thus, unlike the Tokyo Round codes in which adherence was voluntary, members are bound by and cannot opt out of agreements in the areas of anti-dumping, subsidies and countervailing duties, customs valuation, etc. Under these agreements Mercosur countries have, in effect, made commitments to bring their individual practices into line with the new WTO rules and hence to accept a degree of harmonization not apparently yet covered by decisions under the Treaty of Asunción. However, the WTO rules on sanitary and phytosanitary measures were adopted as Mercosur rules at the Fortaleza meeting of the Council of the Common Market.

Second, the Latin American Integration Association (LAIA) provides the umbrella framework for Mercosur, even within the WTO, as noted earlier. Indeed, the first priority for Mercosur in relations with third countries is within the LAIA, where other members have also been undertaking unilateral reforms. In this context, Mercosur countries are renegotiating the Economic Complementarity Agreements, which individual members have with other LAIA members, to create a single Mercosur agreement with each partner. In this regard, negotiations are underway to establish an FTA with Mexico (as an LAIA partial-scope agreement) and Panama.

After five years of operation—i.e., in principle from November 29, 1996—the possibility of admission to Mercosur is open to other members of the LAIA. Bolivia has indicated that it would like to become a member and already participates in some technical groups; in December 1995 it signed an agreement with Mercosur intended to lead to a free-trade agreement. In June 1996 Chile also signed an agreement, which envisages the comprehensive removal of duties on Mercosur-Chilean trade over a 10-year period, except for a small group of agricultural products on which tariffs are to be phased out over 15 to 18 years. This agreement also covers rules of origin (many of which are product-specific), transport investment, services, intellectual property and investment. There is also an interest in developing a link between the Andean Community and Mercosur, fostered primarily by Brazil and Venezuela.

Third, bilateral relations with non-LAIA countries are now dominated by work on the proposed Free-Trade Area of the Americas (FTAA), announced at the Summit of the Americas held in Miami December 9–11, 1994. Work on the FTAA was consolidated by the work of ministers at their Denver meeting in June 1995 and at Cartagena in March 1996, although inevitably the interest of the U.S. administration was diverted in 1996, an election year. The FTAA would extend and consolidate recent autonomous trade reforms in the region, while the inclusion of the United States would also lend considerable credibility to the accord, providing an important guarantee of the outward orientation of Mercosur.

Among Mercosur countries, enthusiasm for the FTAA is not uniform. For example, in a similar context Brazil has argued that joining NAFTA would mean that Latin American countries "would lose their capacity for adopting autonomous policies in sensitive areas such as investment, services and intellectual property." Certainly, such an FTA would also extend liberalization of external barriers beyond the levels currently agreed for Mercosur. In the area of trade, this includes striving for comprehensive agreements across the hemisphere on tariff and non-tariff barriers to trade, agriculture, subsidies, investment, intellectual property, rules of origin, anti-dumping duties, sanitary standards, dispute settlement and competition policy. It also seems likely that the United States would request improved investment opportunities in those countries where investment is subject to restrictions. Similarly, if NAFTA is seen as a model, there would be a need to apply the principles of MFN and national treatment commitments across all sectors (with limited exceptions or reservations), unlike the more lax GATT commitments made by Mercosur countries. Again, even if discriminatory internal taxes have not been raised as an issue in GATT, it is unlikely that they would pass unnoticed in the FTAA negotiation. Overall, import-competing sectors in Mercosur countries (capital goods, automobiles and even some agricultural goods) would come under much greater adjustment pressures in such an FTAA.

Prior to the discussion on the FTAA, Mercosur signed a framework treaty with the United States in June 1991 to encourage trade and investment in the region. This treaty established a consultative council on trade and investment. It set out an initial action program that encompassed Uruguay Round cooperation, means to reduce trade and investment barriers in the Americas, access to technology, intellectual property rights, access to markets for goods and services, sanitary and phytosanitary regulations in agriculture and the need for a transparent safeguard regime in conformity with the GATT.
Under an inter-regional cooperation agreement signed in December 1995 with the European Union, a joint sub-committee on trade began work in 1996. In the longer term, the agreement envisages the opening of negotiations on tariffs and technical standards in the year 2002 with the possibility of establishing free trade between the two blocks by the year 2010. To some extent this agreement is seen as counter-balancing the influence of the United States in the FTAA. There have also been indications of interest in establishing closer trade relations with APEC.

**Sectoral Policies**

The coordination of sectoral policies, which is a feature of a deeper level of integration than the WTO requirements for a customs union, has been the subject of discussions at the technical level in the areas of agriculture, industry, energy, transport and labor. The results of these activities are being incorporated in decisions or resolutions of the higher-level bodies of Mercosur, with the intention that these will lead to greater harmonization of domestic sectoral policies and will further the integration process.

Negotiations are taking place in Mercosur's technical Subgroup 8 to harmonize and coordinate agricultural policies. These discussions are intended to lead to a scheme based on the WTO Agreement on Agriculture. National governments would continue to have complete autonomy on measures falling within the “green box” and “blue box” measures (permitted subsidies, which are general or are delinked in different degrees to the amount of production), while there would be some limitations on national autonomy in respect of measures that are subject to WTO reduction commitments on the Aggregate Measure of Support (AMS). Decision 19/94 of the Council of the Common Market allows the sugar sector to take up to the year 2001 to adapt to the operation of the customs union. Discussions are taking place on the export taxes that are applied independently by Argentina, Brazil and Uruguay on exports of raw hides and skins. The implementation of an umbrella mechanism for agriculture, including a price band (variable levy) system was under consideration in 1995 (Henz 1995), but Mercosur members decided instead to strengthen and harmonize their trade defense (anti-dumping/countervailing) mechanism (WTO 1996a). These discussions are strongly linked to Brazilian concerns about the vulnerability of its farm sector and food security under a harmonization, which would see the elimination of Brazilian farm support policies (Lopes 1996).

Details of the Argentina-Brazil arrangements in the automotive sector are shown in the box below. Effectively, this is a managed trade arrangement, in which the sector benefits from local content plans, allowing concessional entry on vehicles and parts, as well as export-balancing requirements. The arrangements, which have been particularly advantageous for the parts industry, are to remain in force until a common sectoral policy is established in 1999. The present arrangements are covered by a waiver from the provisions of Mercosur under Council Decision No. 29/94. To be compatible with the WTO Agreement on Trade Related Investment Measures (TRIMs), it will be necessary to eliminate the local content and export-balancing requirements by the year 2000. This results from the provision of the TRIMs Agreement that stipulates that all such measures were to be eliminated immediately in 1995 unless notified to the WTO, while those measures that were notified must be eliminated within five years (i.e., by the year 2000) by developing countries. Argentina made such a notification for its automotive arrangements. The status of the Brazilian measures was still sub judice at the time of writing.

In this respect, it may be noted that Mercosur provides a framework for production-sharing arrangements, under provisions that are redolent of the various sectoral arrangements that preceded Mercosur. These are intended to foster the rationalization of investment and to increase the competitiveness of companies in the region (GATT 1992c). A production-sharing arrangement for the steel industry was in place between 1992 and 1994 among Argentine and Brazilian firms, but since January 1995 Brazil has applied duty-free quotas for steel imports from other Mercosur members under the adjustment regime. It is feasible, but apparently has not been discussed, that arrangements in the automotive sector could come under those provisions, but they could not remain as they are because of the TRIMs Agreement.

The extended periods of convergence to the CET for the capital goods and electronics sectors may be seen as part of the coordinated action on sectoral policies in the area of manufacturing. They are also linked to the asymmetries that exist in the economies of Mercosur and, to a degree, a lack of international competitiveness in those sectors. In electronics, Brazil was by far the major producer, but it has
essentially renounced its earlier programs to develop the electronics sector that imposed major costs on other parts of its economy (WTO 1996b). The convergence periods effectively provide a prolonged adjustment period to a more open regime, especially in Brazil.

In the national economies of the Mercosur countries, services now constitute the larger part of national production. To derive greater benefits from international exchange, the Treaty of Asunción provides for free movement of services, capital and workers as well as goods among Mercosur countries. However, while trade in goods has been substantially liberalized, much remains to be done in these other areas where negotiations for a framework were ongoing in an ad hoc group at the time of writing.

The work on services is being carried out by the Ad Hoc Group on Services and its various subcommittees. A framework agreement was scheduled to be submitted to the Common Market Council before the end of September 1997.

In Mercosur there is relatively little integration in financial services, although it is more advanced in banking than in other areas (Machado 1996). However, there are considerable asymmetries in Mercosur financial services markets, and this is reflected in the different offers of the members in the WTO sectoral negotiations, with Brazil’s offers being more restrictive than those of other Mercosur countries, reflecting the earlier stage of sectoral liberalization (Abreu and Bevilaqua 1995). Within the region, it has been agreed through the Protocol of Colonia to apply national treatment to intra-regional investment, with some exceptions, with guarantees for investors. A network of national banks (Red BANOSUR) is intended to find new operational mechanisms to promote intra-regional trade. Subgroup 4 (financial matters) of the Common Market Group has been examining inconsistencies in the capital market regimes and financial systems, and it has drawn up some priorities for cooperation, focusing on supervision, exchange of information, privatization, money laundering and external relations. The work program extends to the year 2000.

In the area of prudential supervision, the Common Market Council in its decision no. 10/93 adopted standards covered by the Basel Agreement of 1988, but much hinges on surveillance and enforcement. Coordination in financial services could usefully be extended to certain basic management principles for financial intermediaries, including standards of accounting and auditing, compatibility of systems, network linkages, user rules and/or rates of commission, but little work has been done by Mercosur in this area.

Transport policy issues have been discussed in Subgroup 5 on transport and infrastructure (previously Subgroup 3 on inland transport and Subgroup 6 on maritime transport). Proposals include the total elimination of standing and flexible quotas for road transport, direct transport between rail terminals, a joint shipping register, labor regimes (stemming from the original Subgroup 11, now Subgroup 10), etc. At present, transport of goods and persons across the frontiers is allowed, as well as returning with cargo or passengers. However, internal cabotage is not allowed. At the Ouro Preto meeting the members adopted a Multi-Modal Transportation Agreement, governing trade operations under a single contract involving more than one transport mode, as well as a Hazardous Merchandise Transportation Agreement, covering the harmonization of regulations on the transport of dangerous goods. Technical discussions are continuing in the area of safety standards, etc.

Discussion has been taking place on the possibilities for harmonization, coordination and regulation in the areas of audiovisual information and data processing and computerized marketing and distribution.

**Technical Barriers**

Mercosur’s Standards Committee, comprising the national standards bodies of member states, has already carried out extensive work on the harmonization of a national standards. Resulting from that work, the council has agreed (Decision 6/96) on the application of the WTO rules on sanitary and phytosanitary measures as the set of rules for Mercosur. To the extent necessary, national measures will be adjusted to bring them into conformity with that agreement. Where further work is desirable in this area, it might be possible to draw on international standards, such as International Standards Organization (ISO), the Codex Alimentarius of the Food and Agriculture Organization (FAO) and World Health Organization (WHO) on food products, or the Office Intenationale des Epizooties (OIE) on animal health; failing this, it could be advantageous to adopt standards from major external markets or suppliers such as the United States or the European Union. This could facilitate exports, making it easier to gain access to foreign markets and expand sales outside Mercosur. On the import side, it would also help to ensure the openness of the customs union.
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BOX 1
Argentina-Brazil Arrangements on Motor Vehicles

In January 1996 Brazil and Argentina signed a bilateral agreement for the automotive sector, revising the text signed between the two countries in Ouro Preto in December 1994. Under the Ouro Preto Agreement, motor vehicles were granted special treatment, while establishment of a common policy on intra-regional trade in this sector was postponed until 1999. In the meantime, Argentina was granted freer access to the Brazilian market than it was required to grant Brazilian exports.

Under the agreement signed in January 1996, vehicles and parts may be imported duty-free as long as the importer balances its foreign purchases with exports to any destination (except for replacement parts). The situation of firms established in only one country had not been defined in early 1996. The agreement provides for an average local content of at least 50 percent computed over a three-year period (Mercosur local-content level is generally 60 percent).

Each partner engages to recognize the validity of the automotive regime of the other country until December 31, 1999. In effect, this formalizes Argentina's acceptance of the changes made to Brazil's domestic regulations in 1995. Under the agreement of January 1996, Brazil and Argentina will meet twice a year to evaluate developments under the agreement and to decide on any necessary adjustments. From January 1, 2000, bilateral trade will be duty-free.

The agreement contains a "side letter" allowing Argentina to compensate the sectoral deficit of US$850 million accumulated with Brazil between 1992 and 1994. Such compensation is to take place through the duty-free importation by Brazil of close to 85,000 Argentine cars between 1996 and 1998. Under the side letter, the two governments were to negotiate the quantities and the use of motor vehicles made by companies installed in the other country. Negotiations were still in progress in 1996.

Under the agreement, imports from third countries are treated less favorably than intra-regional trade. Moreover, the provisions of the agreement make it advantageous for foreign vehicle makers to set up local plants to satisfy the local market. The agreement also seems to favor location of assembly operations in Brazil, as manufacturers are less likely to consider producing vehicles in Argentina for export to Brazil unless they can export the same quantity of Brazilian-made vehicles.

Brazil and Uruguay granted each other an increase of 15 percent in the import quotas for cars, under which assemblers installed in Uruguay (Peugeot and Citroën) were to be allowed to export 11,500 units in 1996. Brazilian exports to Uruguay were to increase from 3,000 to 4,500 cars. In 1995 Uruguay did not fill its quota of 10,000 units, which was extended until March 1996.

Source: WCO (1996b)

On the basis of experience in the European Union, sectors where technical standards may constitute serious barriers to trade and, accordingly, where priority needs to be given to work on standardization, include information technology, telecommunications, transport, construction, pharmaceuticals and foodstuffs. As far as can be readily ascertained, these are areas where there has already been extensive work in Mercosur. A subgroup also appears to be working on an agreement on testing and certification procedures, common conditions and codes of practice for laboratories and certification bodies.

In the short term, full and immediate mutual recognition of national standards (on quality, food composition, etc.) should be the goal. Since the main objectives of legislation for the protection of human health and the environment are generally similar, having identical intentions although often taking different forms, then there is no reason in theory why a product legally manufactured in one country could not be sold anywhere in the customs union. This would obviate the need to meet national standards, with tests and certification in the importing member states, allowing any purchaser—wholesaler, retailer or individual—to choose freely his supplier from anywhere within the customs union.

In the longer term, Mercosur countries could move from mutual recognition toward greater harmonization that allows for even greater rationalization of production to capture economies of scale and specialization. While harmonization implies greater regulation, taking longer to
implement and perhaps introducing inflexibility and stifling innovation, it is sometimes argued that harmonization is more likely to promote cost reductions and the achievement of competitiveness at the international level, particularly in high-technology goods and areas where economies of scale and specialization matter. In the EU, harmonization, rather than mutual recognition, was considered particularly important in the areas of information technology, telecommunications and transport to ensure compatibility between users and operators throughout the customs union. However, these are also areas where Mercosur does not have any evident comparative advantage, and it would be undesirable to establish harmonized standards that effectively operated to restrict access to least-cost sources or world markets (particularly since these are also important inputs into other sectors of the Mercosur economies).

**Intellectual Property**

In the past, the issue of protection of intellectual property was an area where there were significant divergences from overseas practices in the Mercosur area, where intellectual property protection was often based on process rather than product protection and unexploited patents fell into the public domain relatively rapidly. While this has helped some development of domestic industry, it has also been a source of tension in international relations—and no doubt has also had certain adverse consequences in the developing countries, for example by higher royalties to offset risks. Rowat (1993) argues that the increased interest in strengthening laws for the protection of intellectual property is strongly linked to the revisions of the trade and investment regimes, designed to make developing countries more attractive to foreign investors. He describes this linkage as a “marriage of convenience.”

Most international agreements to protect intellectual property are administered by the World Intellectual Property Organization (WIPO), which is responsible, inter alia, for the Paris Convention for the Protection of Industrial Property, first established in 1883; the Berne Convention for the Protection of Literary and Artistic Works, first adopted in 1886; and the Madrid Agreement concerning the International Registration of Marks, adopted in 1891. The most important new development of the international framework is the adoption by the WTO of compromise rules on trade-related intellectual property (TRIPs) issues, which were developed largely at the insistence of the United States because of perceived weaknesses of the WIPO framework. Member states are now bound by the WTO rules, which should oblige a minimum degree of harmonization, including within Mercosur.

The original Subgroup 7 (industrial and technological policy) of the Common Market Group carried out a survey of national laws in the area of intellectual property in 1993 and 1994, and made proposals to the Common Market Group for dealing with intellectual property at the regional level. This was subsequently adopted in Decision 8/95 of the Common Market Council, which in its annex contains the Protocol on the Harmonization of Rules on Intellectual Property concerning marking and origin, which had only been ratified by Paraguay in mid-1997. A Protocol on Trade Marks, Indications of Source and Appellations has been finalized and is also awaiting ratification by Argentina, Brazil and Uruguay. An Agreement on Copyright and Related Rights was approved by the Council, but has been returned to Working Group No. 7 for further study.

**Competition Policy, Reform of the State, and Government Procurement**

Within the market, a technical committee (No. 4) of the Trade Commission is identifying public policies that distort conditions for competition, including government procurement, tax policies and state trading. A common statute on competition polices has been proposed by the Trade Commission to the Common Market Council. Efforts in these areas have been identified as crucial for the consolidation of the internal market by Machado and Markwald (1996). Indeed, the whole area of reform of the state is seen as creating a more favorable economic and institutional environment for integration (de Almeida 1996).

Privatization, one of the key elements of reform of the state, has a number of goals, including the reduction of foreign debt and the control of public-sector deficits. However, a microeconomic objective is the improved allocation of resources, deriving from a more competitive environment. While trade reforms can do much to promote this objective, a proactive competition policy is often necessary to overcome market imperfections, especially in the short term. This has been noted in GATT (1992a) for Argentina and WTO (1996b) for Brazil, but this effort needs to be carried forward across Mercosur in a coordinated manner.
This could pave the way for competition policies to replace anti-dumping on intra-regional trade.

However, despite the extensive privatization that has taken place in recent years, the public sector remains very important in Mercosur (Baer 1995, Shirley 1994). It would therefore be consistent with the goal of improving competitive conditions in the region to increase competition and transparency in public procurement for governments and remaining state-owned enterprises. This means eliminating preferences for domestic suppliers, which are often granted in public-sector contracts and work very much like ad valorem tariffs on imports. (Argentina generally affords national treatment, whereas there are still sectors where Brazil has to move in this regard.) Apart from explicit preference margins, projects are sometimes specifically designed to favor local suppliers, working more like import prohibitions on foreign suppliers. There is often an absence of clear-cut guidelines or transparent tendering procedures, opening the way for corruption of public officials. Major welfare gains could therefore be realized by opening up domestic markets to regional, or, better yet, extra-regional suppliers. Little work seems to have been done in this area. Argentina presented to the Fortaleza meeting of the Common Market Group a proposal to establish an ad hoc group on government procurement, and the group decided to consider this later.

In the WTO, government procurement is one of the few areas where participation is optional, and the Mercosur countries, together with most developing countries, chose not to participate. Assurance of the outward orientation of Mercosur would be enhanced if Mercosur governments chose to sign the WTO Agreement on Government Procurement. This would seem entirely compatible with the need for prudent management of national budgets, and the disciplines on transparency and openness so introduced would also serve as limits on any corruption in letting of procurement contracts.

Infrastructure

Although infrastructure is not specifically covered by the Treaty of Asunción, it has been highlighted in GATT (1992a and 1992b) that the trade of Mercosur countries would be facilitated by improved physical infrastructure, particularly ports and airports. A particularly telling example is the degraded port and transport situation in Paraguay, described in World Bank (1993). There would also be benefits from improved road and rail connections in the Mercosur area. In the current financial situation of the member states, it may be opportune to look further at the possibilities for privatization in these areas, as has already been done for bulk shipments of grains and minerals.

Coordination of Macroeconomic Policy

The Treaty of Asunción provides for periodic meetings of Ministers of Economy and Central Bank Governors of Mercosur countries to coordinate of macroeconomic policy and to try to establish joint approaches to common problems such as inflation, foreign investment and trade. In practice, there were no meetings between 1995 and 1997 (until a meeting in Asunción in April 1997 to consider, among other things, Brazilian restrictions on the financing of imports). In the past the lack of coordination on macroeconomic policies has been most evident with respect to exchange rates (Abreu and Bevilaqua 1995, Pereira 1996). For example, differential movements in exchange rates and interest rates in Argentina and Brazil caused major fluctuations in trade and financial flows, giving rise to political tensions and to new trade measures. This has sometimes led to managed trade solutions, instead of corrective macroeconomic policies. For example, at one point, to reduce tensions and help to overcome rising trade deficits, Brazil made “special efforts” to buy more from Argentina (e.g., through state-owned enterprises). The Argentina-Brazil automotive arrangements, stepped-up efforts by Brazil to promote exports and, most recently, Brazilian restrictions related to the financing of imports may be seen in a similar light.

One approach to convergence in macroeconomic management might be the establishment of targets, such as the European Union has set as a condition for participation in the planned monetary union. These cover inflation, long-term interest rates, exchange rates, budget deficits and public debt, all consistent with macroeconomic stability, which, as Pereira (1996) points out must be the basic goal more than rigid targets. However, efforts to restrain fiscal expenditure are complicated by the ineffectiveness of federal controls over the provinces in Argentina (now being brought under control) and the states in Brazil. Again, exchange-rate corrections are complicated because Argentina has pegged its currency to the U.S. dollar, and Argentina’s use of monetary policy is also effectively excluded by its Ley de Convertibilidad, requiring all cur-
Trade towards open regionalism

Currency issues to be fully backed by U.S. dollars (in essence a currency board system); this leaves economic management essentially to fiscal policy, for which financing is also limited by the outlawing of the monetization of government deficits. It is constraints such as these that have led to the use of special arrangements, lists of exceptions to the CET and safeguard actions to manage trade in recent years, going against the spirit and intent of a common market, not to mention the WTO.

The original Subgroup 10 on coordination of macroeconomic policies carried out an examination of taxation issues, particularly in the area of consumption taxes. In principle, this work was handed over to the Ministers of Economy and Central Bank Governors, but, as noted, there were no meetings between 1995 and 1997, and no specific actions have yet been taken along these lines, despite the range and complexity of internal taxes, including those at the provincial and state levels in Argentina and Brazil.

This divergence in rates has encouraged “shopping tourism” for which Paraguay, where indirect taxes are low, is a regional center. However, little progress has been achieved on tax harmonization, and the possibilities for agreement must inevitably be complicated by the current process of reform of domestic taxes in each member, intended to overcome tax evasion and lift tax receipts.

The case for coordination or even harmonization of indirect taxation is to avoid resources flowing from one member to another, not on the basis of resource endowment but rather on avoidance of potential tax liability. Harmonization would also reduce the risks of fraud and smuggling that occurs today. Pita (1996) argues that it is necessary to accelerate the institutionalization of the processes of tax harmonization to gain the full benefits of integration. There might also be some harmonization of tax incentives for investment, domestic or foreign. However, in the present fiscal situation, it is difficult to foresee any Mercosur agreement on the establishment of an EU-type mechanism whereby goods would only be taxed at the point of production, passing across frontiers without border tax adjustments.

Conclusion

The Mercosur countries have taken important steps toward the construction of a customs union, and beyond that toward a common (but not EU-style single) market. This work has been accomplished in a relatively short time-frame. Concerns about possible trade diversion should be allayed by the extensive unilateral reforms, the major increase in tariff bindings in the Uruguay Round, the removal of many non-tariff measures and the additional disciplines of the WTO, which also add a degree of security to trading conditions for third countries. So far the rapid increase in trade flows between members has been accompanied by a solid growth in trade with third countries.

To complete internal free trade in goods requires the elimination of the remaining tariffs on intra-Mercosur trade, and a number of non-tariff measures have yet to be eliminated or harmonized; in most areas, this work is either in process or is being discussed. While the intention is to allow free circulation of goods, the weakness in administrative arrangements for free circulation represents a serious gap in the completion of a customs union; there is scope for improved implementation of agreed streamlined customs operations. The provisions for sectoral policy coordination, including production-sharing arrangements, need to be monitored to ensure that they do not revert to earlier import substitution policies. No agreement has yet been reached on free movement in services, capital and workers, despite the commitment to include these by January 1995. Mercosur needs a strong and coherent competition policy to improve the competitiveness of domestic industry, and this could also replace anti-dumping procedures in intra-Mercosur trade. Opening up public procurement regionally and beyond could bring both welfare and direct fiscal benefits. A supranational framework may be needed to advance and deepen integration in investment and services, and some steps have been taken in this direction. In the meantime it remains to be seen if formal dispute settlement procedures are sufficient protection for the smaller countries.

Given the history of macroeconomic instability in the region, often linked to reversals of previous trade policy reforms (Papageorgiou, Michaely and Choksi 1991), one of the highest priorities for the authorities must remain coordination and cohesion in the pursuit of responsible fiscal, monetary and exchange-rate policies to achieve economic stability with steady growth, perhaps with specific targets for key economic variables. As we have seen, the failure to achieve such coordination can lead to disruptive imbalances in trade, reversals of trade or exchange-rate policies, and deteriorating political as well as economic relations. The resort to managed trade solutions, particularly in automo-
biles, run counter to the spirit of recent unilateral trade reforms and the common market, not to mention the WTO.

On external policy, there are still a number of important exceptions to the common external tariff, including those that come through flexible additional lists that have provided legal cover for recent policy reversals, but the programmed elimination of these measures is still within the agreed timetable. In the longer term, greater welfare benefits could be realized by scaling back escalation in the CET and the elimination of TRIMs exceptions in the automotive sector. Between members, there seems to be more competitive than coherence of approach in attracting foreign investment, and this also seems to have linkages to the outdated import-substitution policy. While efforts are being made to agree on a common anti-dumping mechanism, consideration might be also given to using competitive policy standards on external trade to avoid possible abuse of anti-dumping actions whose use has become important, especially in Brazil and Argentina.

External trade relations are still centered on other LAIA countries and talks with Andean Group members, which could lead to a virtual South American FTA. There seems to be a more ambivalent interest in the proposal for a Free-Trade Area for the Americas, which would have the advantage of extended market opportunities, greater economies of scale in production and distribution, the dilution of the power of national industrial lobbies and greater discipline on potential policy slippages.

The potential welfare gains from completing efforts on internal and external barriers, ensuring the smooth functioning of trade and looking beyond existing plans to a lower and more uniform structure of protection are very large, although their attainment will entail adjustment for these sectors, which hitherto have flourished under protected, uncompetitive markets. The willingness of the member countries to confront the “hard cases” will constitute a test of the depth of change in the economic philosophies of the member states.

References


Notes

1. Of course, there is trade diversion if the counterfactual is free trade.


3. Mercosur is formally a subregional agreement within the LAIA framework.

4. However, Article XXIV requires that a customs union or FTA cover substantially all trade. For those items that are included, "duties and other restrictive regulations are [to be] eliminated"—i.e., that there is to be a 100 percent reduction in tariffs and other barriers. A preferential rate other than zero is not contemplated.

5. Disagreement about GATT consistency is the norm; conformity with GATT Article XXIV has been explicitly acknowledged in only six out of 69 cases where reports of working parties were submitted to the GATT Council. See WTO (1995b) for further details.

6. A headquarters agreement (Acordo de Sede) with the Uruguay government was agreed under Decision 4/96 of the Common Market Council at its December 16–17, 1996, meeting in Fortaleza. Financing of the secretariat is on the basis of equal cost-sharing among members; there is no independent source of finance.

7. Legislative ratification and national implementation sometimes lags behind the commonly agreed measures. For example, in early 1997, the author was informed that, out of the total of 97 decisions, 501 resolutions and 43 directives approved in the period 1991–96, Argentina and Brazil had ratified somewhat more than 50 percent. This is less serious than it appears, because some of these legal measures merely concern the undertaking of studies rather than mandating behavior.

8. The case involved a Uruguayan paper firm that complained that Argentine levies were not in the exception lists established at Ouro Preto.

9. The number of items is computed on the basis of the Mercosur tariff classification. The number of tariff items would be somewhat higher if measured in terms of the pre-existing national tariff classifications.

10. Imports from export-processing zones are normally treated as imports subject to the CET.

11. Unusually, in the GATT/WTO context, this requirement refers to applied tariffs, rather than to tariff bindings.

12. Nogues (1983) notes that in Argentina the average nominal tariff was reduced from 98 percent to 49 percent in the Martinez de Hoz period (1976–81), and stood at more than 50 percent in 1988, but the ratio of duty collected to total imports was close to 2 percent for all the years between 1970 and 1988. This was a result of concessionary rates as well as preferences.

13. Paraguay acceded to the GATT during the Uruguay Round with a comprehensive binding coverage.

14. Estimated protection would be even higher if the tariff reductions on inputs announced in late 1995 were included. The industry is further assisted by non-tariff measures—e.g., export subsidies and investment incentives.

15. The level of the Argentine statistical tax has varied between zero and 6 percent in recent years.

16. It may be noted that, since 1992, no anti-dumping actions have been allowed on intra-regional trade in the EU and the European Economic Area, with reliance being placed solely on common competition policy enforcement. The same is the case in the Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA).

17. During the period of implementation when national exceptions to the CET are allowed, the difference between the CET and the national level would be paid (or, in principle, rebated where the national rate is lower) on entering the market of final destination.

18. Member countries of LAIA are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela.

19. Since Chile now has an FTA with Mercosur, it is not obliged to change its uniform 11 percent tariff to the Mercosur CET. This also will allow Chile to maintain its FTAs with Canada and Mexico as well as pursuing its possible NAFTA accession.

21. Article III of the GATT prohibits discrimination against imports in the application of domestic taxes.

22. In developed economies, these sectors are often supported under research and development programs as well as defense contracting.

23. There has been a substantial restructuring of Latin American banks, linked in some instances to inefficient and corrupt management (see "Banks in Latin America: An Urgent Case for Repair" and "Miami or Bust" in *The Economist*, July 1, 1995, pp. 79–80). The situation deteriorated because of the Mexican financial crisis, but this was not the prime source of the problems.

24. This was also a matter of extensive debate and legal action in the European Union. See, for example, the Cassis de Dijon case (Rexo-Zentral AG v Bundesmonopolverwaltung für Branntwein, ECJ case 120/78) that determined, inter alia, that differences in national marketing laws should only be allowed as a restriction on free movement of goods to the extent necessary for the enforcement of fiscal supervision, protection of public health, fairness in commercial transactions and defense of the consumer.

25. Baer and Shirley, taking different views of the lessons from privatization, provide a useful overview of the importance of the state sector in Latin America. Baer mentions that there were some 353 state-owned enterprises in Argentina in the 1980s, 268 in Brazil and more than 1,000 in Mexico. Shirley notes that Latin America is the major privatization area in the world, generating revenues of some US$40 billion in the period 1988–92.

26. These targets have prompted the comment that the conditions of membership are like a slimming club's requiring weight loss prior to admission ("From here to EMU," *The Economist*, August 5, 1995).

27. Da Silva (1996) points out that Brazil would probably have to make the major effort since its tax system contains elements that significantly distort the efficient allocation of resources.

28. Tax harmonization does not necessarily imply absolutely identical rates of taxation. For example, it is possible to envisage a fixed percentage variation from an agreed norm or target across member states.
VI. Roundtable: The Small Economies
The Challenges to Small Economies

LUI S MOSCA

THERE IS SO FAR NO CONSENSUS ON WHAT CHALLENGES THE SO-CALLED SMALL ECONOMIES are actually confronted with in a globalized world economy, and particularly not when they belong to large regional groupings.

The difficulty here may lie in the very definition—perhaps too simplistic, or mistaken—of what constitutes a small economy. Undoubtedly, there is a confusion in terms, because, with very few exceptions, the world's economies are all small, in the sense that they are unable to isolate themselves or determine the course of external events. In addition, many large-scale industrial or service activities with worldwide presence and impact are located in geographically small countries.

Good examples are the chemicals industry in Switzerland and electronics industry in the Netherlands. So, from the outset, let us be clear that the relative nature of the definition limits the possibilities for analysis considerably.

At the present time, there is not one set of problems specific to large economies and another to small economies. We are simply dealing with new issues, and some not so new, arising out of the growing interrelationship linking nations for economic, technological and cultural reasons. Each country perceives these new issues as new challenges, which it tries to resolve from its own specific position.

I do not believe there exists a typology of challenges that parallels the size of countries. What does exist is a generalized set of conditions in which all factors external to a country have significant internal connotations for it. In my view, this precisely is the correct stance for determining which challenges to resolve in the prevailing circumstances, and for formulating a strategy by which to overcome them.

In the particular case of an economy that operates under the conditions and in the situation of that of Uruguay, at least three issues emerge clearly as challenges, and it is on these that I want to focus here. The first issue is whether it is possible to mitigate the impact of external shocks, mainly regional, so as to enhance the effectiveness of public policies and prevent social conditions from deteriorating when the regional economic cycle is adverse. The second is the importance of a better understanding of the investment dynamic within areas such as Mercosur, a key consideration for economies such as Uruguay's, where present investment levels are too low to support higher growth rates. And the third has to do with exploring the right stance for economies in situations similar to Uruguay's to adopt toward the new generation of agreements that are expanding the areas of economic interrelationship. The FTAA is a good example.

Reducing External Volatility

Greater interdependency and integration mean increasing the level of domestic accommodation to external events. The apparent loss of independence that this entails in the design of domestic policies is obvious, but at most the

Luis Mosca is the Minister of Finance of Uruguay.
question is one of degree and not one of substance, since experience demonstrates in the end that external occurrences tinge all countries' internal events in one way or another.

Nevertheless, recognizing this reality does not mean ignoring the importance of instituting strategies or policies designed to reduce the domestic volatility it causes. The aim is to enhance the effectiveness of the policies adopted and lower the concurrent social costs. I believe this to be an area of challenge where we cannot yet claim enough proven experience, except in seeking to diversify our external markets as much as possible and reduce the distortions affecting domestic factor markets. In any case, I have the impression that what has been done has not been sufficient—and neither is the number of proposals put forward. I am, of course, not providing an answer here. What I am doing is raising a question to help catalyze opinions, although I suspect that we are faced with a problem in which the number of unknowns exceeds the number of available tools.

As a final warning against falling into temptation, I must add that the facts demonstrate that in integration systems, particularly on a regional scale, effective coordination among countries on such concerns as macroeconomic policy still languishes in the "topics pending" category.

**Investment Dynamics in Economic Integration Areas**

It is indisputable that investment is a key factor in sustaining high levels of growth and improving social conditions, the ultimate objective of all government policy. In this equation, private-sector investment is pivotal: It has been demonstrated that current levels of global investment are too low, and that public-sector investment, apart from being limited for fiscal reasons, is inefficient in the majority of cases. In countries like Uruguay, with a low level of domestic saving and a correspondingly low level of investment, the crucial question is how to raise the latter. The next question concerns the likely impact of integration processes on the choice of foreign investment sites. One intuitively tends to assume that expanded areas like Mercosur are focal points for foreign investment. This means that for the so-called small economies the challenge then becomes that of orchestrating an appropriate set of conditions that will facilitate the process of attracting investment to themselves, and of subsequently plotting out the likely pattern of specialization in production and services among the partners involved. This latter point is of singular importance, given that the invariably limited degree of public-sector investment is merely a complement to private investment. Thus, prior identification of likely investment areas reinforces the process of external investment and the effectiveness of public-sector capital spending.

I would like to draw attention to three considerations that I regard as looming large in this issue: First, services are not a field of activity where investors need to assure themselves of minimum market dimensions independently of the future course of integration agreements, or where choice of location is dictated by the availability of specific resources. Second, decisions on site choices and development plans where services are concerned are very sensitive to regulatory environments, to the point that it is differences between these that are the real persuaders when it comes to selection of this or that country as an investment site. Third and last—and as an adjunct to the second consideration—the regulations governing factor markets, including the labor market, are the reality that underlies basic entrepreneurial decisions. Tariff structure is merely one dimension in the universe of inter-country integration, and one component more—although a major one—in the taking of a final investment decision. To dwell just on this question, and attempt to come up with the perfect tariff system, is to stay on the margins of the subject of investment site selection.

All the same, countries need to ask themselves what tariff-like measures affect foreign investors' decisions on the geographic siting and the development of new activities. Not to go into this question thoroughly is to risk losing out seriously in the distribution of the results of integration, with the smaller-scale economies being left furthest behind.

In my view, discussion of this aspect of the investment dynamics at work in the integration process is essential.

**Small Economies and New Integration Systems**

Developments in the region show that the present integration systems are expanding—Mercosur in particular. The addition of new partner countries to this system, the signature of a framework agreement with the European Union in 1995, and the commencement of conversations on adjustments to the FTAA are the most recent proofs of this expansionary trend. Its impact on the region's small-scale economies, and particularly on countries such as Uruguay,
definitely will be major. One of its clearly positive effects is that it is accompanied by market growth and extension, which help to moderate the fluctuations that external events provoke in the domestic activity levels of the countries in the region.

However, the expansion of these agreements makes formulation of member states' participation strategies that much more of a challenge. Two examples of the kinds of problems that have to be resolved are correct sequencing of issues for consideration during the course of negotiations and configuration of the new economic spaces.

Another problem will be how to treat very sensitive sectors like temperate-zone agriculture, an activity that enjoys strong protection in new partner states while at the same time constituting one of the production mainstays of many small and already very open economies. Is there a possible compromise course that would free us from long transition periods sure to dilute the expected beneficial impact on the general welfare? Our concern stems from our having been witnesses over the last decade to unprecedented openness and growth in international trade. However, there were areas that fell behind as the process went ahead, with many countries still given to excessive protection of key sectors like agriculture; the result is that the effects of global liberalization are still few and far between in such sectors. This is one of the challenges facing small countries like Uruguay, since continuation of this state of affairs adversely skews the natural costs of every integration process, preventing expansion of those activities in which such countries might enjoy major comparative advantages, and therefore also the improvement of their welfare status.

**Conclusion**

The dichotomy between large and small economies has no practical consequences, with rare exceptions. There is thus no specific typology of challenges to be dealt with by the countries in each group. The differences between them are more a matter of degree than an absolute linked to their size. Nevertheless, problems do exist, and we are constantly trying to resolve them, despite being aware there is no single solution to apply.

The issues reviewed here probably belong in that category, too. However, given their significance where our countries and progress with integration are concerned, I believe it is important to put them up for debate, and for us to be aware that in the course of our search for solutions other new issues will appear that are going to present us with other challenges.
The Challenges to Small Economies

FERNANDO NARANJO

To precisely define the concept of smaller economies is no easy task. There are different ways to determine the economic dimensions of a country. There are economies that may be considered small if we take into account variables such as land area and population, although some of these countries have achieved great economic development. In this sense, we could mention economies in different parts of the world that have achieved a high degree of development, being small in one or both of the above-mentioned variables—for example, Singapore and Taiwan, China in Southeast Asia or Switzerland and Denmark in Europe, which, in spite of their geographical dimensions and the size of their populations, have achieved very high economic development standards. The economic dimension also could be measured by taking into consideration the GNP, foreign trade or per capita income. All of these criteria are imprecise.

In spite of the difficulty to define what the "smaller economies" are, in general they present certain special characteristics, such as:

- Reduced internal markets, resulting in the lack of adequate infrastructure; less ability to take advantage of the economies of scale, causing low productivity rates; and, in general, higher costs per unit of production.
- High dependency, especially in the developing world, on just a few export products, which generates a greater economic vulnerability due to price variations or to seasonal factors.

But even after considering these characteristics, to say that size is an insurmountable obstacle for development is not a valid argument, although some insinuate that it is. There are some highly developed small economies and others with a very limited degree of development.

In the context of the globalization and economic integration processes, the theme of "special and differentiated treatment" for the small economies arises. This element has been recognized by the agreements of the World Trade Organization (WTO), where it is stated that the small economies may delay the application of some of the clauses of the agreement and the developed countries should provide technical assistance in different areas to the developing countries as may be required. Likewise, in the North American Free Trade Agreement (NAFTA) and Mercosur, schedules for the reduction of tariffs are stipulated for Mexico (in the case of NAFTA), and for Uruguay and Paraguay (in the case of Mercosur).

The element of a special and differentiated treatment was also recognized by the presidents and the heads of state of the hemisphere when they included the following paragraph in the Declaration of the Miami Summit in December, 1994:

We recognize that the economic integration and the establishment of a Free-Trade Area are complex objectives, particularly because of the difference in

Fernando Naranjo was Foreign Minister of Costa Rica.
the levels of development and the sizes of the economies of the hemisphere. We will be aware of these differences while we work toward achieving the economic integration of the hemisphere.

We will use our own resources, creativity and individual capacities, as well as those of the international community to help each other in achieving our objectives.

And in paragraph 5 of the principles of the Plan of Action it says:

While we work to achieve the Free-Trade Area of the Americas, opportunities, such as the provision of technical assistance, have been foreseen to facilitate the integration of the smaller economies and increase their levels of development.

It is clear that the smaller economies have their very own and special characteristics. To request longer time frames for trade liberalization is not, by any means, an evasion of the responsibility assumed in the processes of integration and free trade. Moreover, it implies the adjustment of responsibility and reciprocity to guarantee the sustenance of regional accords. The first conclusion I would like to emphasize is that smaller economies may not and should by no means remain isolated from the benefits of globalization.

Central America has been participating in the transformations that have been occurring throughout the world and that represent for the area a series of positive developments. Nevertheless, the potential offered by the world environment has not been sufficiently taken benefit of, due to some persistent structural and institutional weaknesses and distortions that have been present in the region for decades.

With the deactivation of the armed conflicts and the establishment of peace in Central America, the challenges of reconstruction, integration, structural adjustment and development have emerged as the main axis of the Central American economic agenda. It is important to emphasize that today there is an awareness of the close relationship between the urgency to advance in the economic and social spheres and the capacity to sustain political achievements.

Likewise, an "outward bound" vision of Central America based on the consolidation of the regional market and its insertion in the world economy is now in place. Almost three years ago, at the Central American Summit of Guacimo, Costa Rica, the foundation for the new Central American process of development and integration was set. I refer to the Alliance for Sustainable Development, or ASD, which is the conceptual framework that the presidents defined for the region.1

In the middle of the profound political transformation experienced by Central America during the last decade, from war to peace, free elections and the strengthening of democratic institutions, the region has taken far-sighted steps to ensure its insertion in the world economy. The degree of liberalization of the economy has accelerated, liberalizing in good measure the trade regimes and the financial systems. All these changes were undertaken unilaterally, as well as under the multilateral processes within the framework of the World Trade Organization. Additionally, exports have been diversified toward light manufacturing, nontraditional agricultural products and maquila. More recently, in Costa Rica, a small high-technology cluster is being developed.

Sound stabilization policies, trade liberalization and structural adjustment measures put in place by the governments in the '90s have induced important capital flows, particularly direct investments. Nonetheless, in spite of these significant advances, Central American countries must increase their internal savings capacity and strengthen their macroeconomic stability, so that they may generate productive investment processes that sustain economic development over time, improve infrastructure and provide better services and carry out activities with a higher added value and technological content.

Central America has a population of 32 million inhabitants. In 1996, the GNP reached almost US$40 billion, with a per capita income of US$1200, total exports of the region were almost US$8 billion (20 percent of the GNP), of which intra-regional trade accounts for US$1.6 billion (20 percent of the total). The main destination of the extra-regional exports is North America, where more than 50 percent of the exports were sold. While the European Union is the second most important market, trade with the rest of Latin America is only just beginning.

Central America is a medium-size economy. Its market is attractive for the world's industrialized countries and for many Latin American countries even more, if we take into account that the regional free-trade zone has been consolidated and considerably improved in recent years. These achievements have been successful in spite of the disparity
in income levels and the degree of trade liberalization, which are very significant among these countries.

The Central American nations, and small countries in general, must advance in regional integration schemes that allow them to achieve more substantial benefits than those they may obtain by acting on their own. In unity there is strength, and on this subject our experience is valuable. Since August 1994 our presidents agreed that trade negotiations would be made jointly as a region.

Before this decision was taken, Mexico and Costa Rica signed, at the beginning of 1994, a free-trade agreement, which has encouraged trade between both nations, especially during 1996 and 1997. The rest of the Central American countries have advanced significantly in their bilateral negotiations for a free-trade agreement. At the end of this phase the objective is to reach a Mexico/Central America Free-Trade Agreement to establish a Middle America free-trade area, a market of 120 million inhabitants.2

During the next few months, a free-trade agreement is expected to be signed between Central America and Panama, and initial discussions are under way to begin trade negotiations with the Dominican Republic and with CARICOM.

In the second half of 1997, a political, economic and cooperation framework agreement between Chile and Central America is expected to be signed. This instrument will establish a strategic and privileged relationship between our region and Chile. Likewise, in the following months a political rapprochement is foreseen with the countries of Mercosur.3

Last May 8, on the occasion of the visit of President Bill Clinton to San José, the presidents of Central America indicated to the American president their satisfaction with his commitment to extend the benefits of the Caribbean Basin Initiative, as they expressed emphatically and plainly Central America’s wish to negotiate, in the near future, a free-trade agreement with the United States.

My second conclusion is that Central America expects to be a key player in the integration process of the hemisphere. We are fully committed to take Central America beyond the region. We feel that through the consolidation of the regional free-trade area, jointly with the integration process in different fields, and the joint trade negotiations, we will be in a better position to take advantage of the opportunities of globalization.4

The smaller economies have great opportunities to benefit from the formation of a free-trade area of the Americas, but, at the same time, they are the ones that have greater possibilities of incurring relatively higher costs if they do not prepare adequately to reap the most benefits from their international economic insertion. Possibly, the smaller economies are the ones with the most opportunities to benefit from the hemispheric integration, although as a paradox, the risks and the preparation process itself are greater for them.

The factors that determine the possible costs and benefits are not precisely the most favorable in the great majority of the smaller economies. Factors such as the macroeconomic environment, capacity to face competition, the investment climate, the attitude of the entrepreneurial sectors, physical infrastructure, and education of human resources are essential to successfully take advantage of the international trade.

To incorporate efficiently into the processes of globalization it is important that the smaller economies be prepared. This refers to the necessary factors a country requires to achieve successful access into international trade. Among these factors one should mention the macroeconomic conditions of price stability, healthy management of the internal and external debt, exchange-rate stability, and non-macroeconomic conditions such as international commitments in matters pertaining to trade, human rights, the environment, intellectual property and labor regulations.

To obtain maximum benefits from the process of economic liberalization and to be able to compete efficiently, programs and specific actions are required. The liberalization does not generate automatic increases in the degree of competitiveness. There are structural factors that must be changed to take advantage efficiently of the trade and investment opportunities that a process of economic integration offers. In the case of the smaller countries, the infrastructure limitations, inefficient capital markets, untrained workforce, and other deficiencies limit the ability of these countries to take full advantage of these opportunities. Besides, there are a series of key microeconomic factors that are essential to increase productivity and competitiveness of the economies.5

My third conclusion is that although the cost may be high, the smaller economies must fully and decisively prepare to face the challenges of globalization. Even though the cost of integration could be higher for the smaller economies, the question we should ask ourselves is, What
is the cost of not timely integrating and of not taking advantage of the potential benefits?

One last word on technical and financial assistance: The larger countries and the multilateral organizations must play a key and decisive role in this field. Without this support the way may be steeper for the smaller economies. Shouldn’t the hemispheric integration process precisely serve to help the smallest and the least developed?

We then can conclude in fourth place that technical and financial assistance, bilateral and multilateral, is decisive for the smaller economies.

Notes
1. ASD is based on four important elements: (i) Democracy as the basic form of human coexistence and only way to achieve well-being and justice; (ii) The transformation, modernization and the liberalization of the economies; (iii) The dependency on the market mechanisms and the harmonization of economic policies among the Member States of CACM; and (iv) Investment in the human being, particularly in education and health as a key element to give sustenance to the political and economic transformation of the region and the alliance with nature, so that the 12 percent of the biodiversity of the planet, which is located in Central America in less than 2 percent of the world area, may serve as an instrument for the promotion of sustainable development in the future.

2. The Presidents of Central America and Panama and the Prime Minister of Belize met in San José Costa Rica in February 1996 with President Ernesto Zedillo of Mexico. This was the second meeting of the eight heads of state. This last meeting, known as Tuxtla 11, represents a historic landmark in the integration process of the region, where the eight countries decided to move on a preferential relationship on the basis of a joint agenda, which included political, economic, social, cultural and environmental issues. In the second half of 1997 the first follow-up meeting of Tuxtla 11 will be held.

3. In principle, the first meeting of the Ministers of Foreign Affairs of both regions will take place in September 1997.

4. Very important steps are being taken to integrate the electrical systems, passenger transportation, tourism promotion, conservation of the environment and stock markets, among others.

5. In the Central American case, Harvard University, through Professor Jeffrey Sachs and Michael Porter, with the support of INCAE and the Central American Integration Bank, and with the active participation of the entrepreneurial sectors, are working on an intense program to increase efficiency and productivity.
VII. Roundtable: Agricultural Policy and Integration
Regional Trade Agreements: The Case of Agriculture

BRUCE L. GARDNER

In recent years there has been enlightening experimentation with combined unilateral and regionally integrated agricultural and trade policy reform in Canada, the United States and Mexico. Major steps in formal regional integration were the Canada-U.S. Trade Agreement (CUSTA) and the North American Free Trade Agreement (NAFTA), which came into effect in 1989 and 1994, respectively. During this same period, substantial domestic policy reforms occurred in all three countries, and the Uruguay Round agreement on agriculture in the GATT was concluded. These events provide an opportunity to investigate several issues and questions that arise concerning the prospects and pitfalls of regional trade agreements.

The main conclusion I arrive at is that the agricultural provisions of NAFTA/CUSTA have been a surprising success in opening agricultural markets. Success is surprising because of obstacles that faced the negotiators due to the dogged opposition of interest groups (commodity producers) who expected to lose from liberalization, and obstacles those same political forces placed in the way of meaningful implementation. The reasons for this success, and the implications for the broader issue of assessing regional trade agreements on an economy-wide basis, remain unclear.

Politics and Economics of NAFTA
The chief political problem facing the U.S. negotiators was that the opponents of NAFTA had reasonable prospects of stopping the U.S. Congress from ratifying and implementing any agreement. Therefore, they had to win the support of these interests, or at least soften their opposition, by building in protections for these industries—i.e., by not liberalizing. So, for example, tariffs were reduced in easy stages, and "safeguards" were included to permit tariffs to be restored if imports increased substantially.

Some commodities received further special treatment. Consider the case of sugar. Sugar in the United States is protected by import restrictions that keep the U.S. domestic price of raw sugar at about double the world price (currently 22 cents per pound for domestic raw sugar traded at New York, compared with a world price of 11 cents per pound). U.S. sugar cane growers were concerned that NAFTA would seriously damage the U.S. sugar pricing regime, notwithstanding the fact that Mexico is a sugar importer. Mexico, however, did ask for access to the U.S. market for 1.5 million tons annually in the NAFTA negotiations (an amount only slightly below the total of current U.S. sugar imports). U.S. sugar interests worried that Mexico would import U.S. corn under NAFTA and make high fructose corn syrup for use in Mexican soft drinks to such an extent it would cause an excess supply of sugar in Mexico, which would then be exported to the United States and ruin the U.S. sugar price-support system. The upshot was that Mexico received only very limited access to the U.S. market, for up to 0.25 million tons annually in years seven through 14 of the agreement. In the end, U.S. sugar's...
TRADE TOWARDS OPEN REGIONALISM

Figure 1A
U.S. Agricultural Imports: NAFTA Countries

![Graph showing U.S. agricultural imports from NAFTA countries over years 1990-1996. The bars indicate imports from Mexico and Canada.](image)

U.S. Agricultural Exports: NAFTA Countries

![Graph showing U.S. agricultural exports to NAFTA countries over years 1990-1996. The bars indicate exports to Canada and Mexico.](image)

The economic situation was unchanged by NAFTA. In addition, sugar also largely withstood challenges to its protected position in the Uruguay Round of GATT and in the U.S. farm policy reforms of 1990 and 1996. Any increased U.S. imports of Mexican sugar will be offset by reduced imports of sugar from some other country (as also happened when the Reagan Administration in the 1980s increased selected countries’ import quotas as part of its Caribbean Basin Initiative).

These and other anecdotes too intricate to be detailed here provide observations relevant to the political economy of regional trade agreements. (For an illuminating description, see Orden 1996.) To organize discussion of the implications more systematically, I will list four hypotheses, then will discuss the implications of further observations about CUSTA/NAFTA for the truth of these hypotheses.

First, there are hypotheses concerning the possibilities of negotiating trade agreements. In particular:

1. Regional agreements and unilateral domestic reforms tend to be complementary activities, in the sense that negotiations on one make it easier to achieve the other.

2. Regional agreements make it more difficult to achieve global agreements such as GATT.

Second, there are hypotheses about the fate and consequences of regional trade agreements, once reached:

3. Regional agreements tend to be loosely specified statements of intentions or more precisely specified targets that are either easily evaded or already achieved; therefore, the agreements tend to have little effect.

4. To the extent that regional agreements have real economic effects, they tend to result in less trade between the region and countries outside the region (trade diversion).

What were the political forces that permitted NAFTA? I will speak only to agriculture in the U.S. context. The key underlying element of the situation, and of the truth in hypothesis 1, is that the toughest negotiations involve each country’s negotiating with itself, i.e., among its interest groups. What made NAFTA possible politically was...
the existence of winners as well as losers among domestic producers. U.S. feed grain, livestock and food processing industries expected to gain from NAFTA. They wanted NAFTA to achieve substantive increases in their export opportunities. Some fruit and vegetable producers, especially those in Florida, expected to lose, as did sugar and peanut growers. The losers mounted strong campaigns of opposition to NAFTA. But given the division of interests, and a strong push for an agreement by both the Bush and Clinton administrations, the liberalizing forces were able to gain the day.

Nonetheless, the potentially losing interests were able to build protections for themselves into NAFTA and in domestic legislation. Sugar, peanuts and other protected commodities have been able to keep their price supports largely intact. In this respect the U.S. agricultural policy debates and limited reforms in 1990 and 1996 fit in well with NAFTA and helped it succeed.

Because CUSTA and NAFTA have in fact gone into effect and we can look at the preliminary results, some evidence on hypotheses 3 and 4 is available. Tariff reductions and gradual elimination are coming into effect slowly under NAFTA, beginning in 1994. However, the events that have received most attention under both CUSTA and NAFTA are the many disputes that have arisen over trade expansion. I will focus on protectionist impulses that have developed in the United States. Two cases in particular involved formal complaints to the U.S. International Trade Commission (ITC) by U.S. producers and ended in trade-restricting bilateral agreements: winter tomatoes and bell peppers from Mexico, and durum and spring wheat from Canada.

After tomato imports from Mexico increased sharply in the winter of 1996, growers led by those in Florida filed a petition for relief with the ITC, alleging dumping of tomatoes by Mexico. The ITC in July 1996 issued a preliminary determination that the tomato industry had not suffered serious injury, but it left the dumping allegation open for a fuller investigation. In October, the United States and Mexico reached an agreement on minimum prices for Mexican tomatoes sold in the United States.

In the Canadian wheat case, U.S. wheat growers sought protection based on a U.S. law that calls for limitations on
imports when such imports interfere with a price-support program. In November 1993 President Clinton, seeking to assure wheat growers that their interests would be protected under NAFTA at a crucial point in the debate on U.S. acceptance and implementation of the free-trade agreement, wrote to the ITC stating his belief that wheat was being imported "under such conditions or in such quantities as to render or tend to render ineffective, or materially interfere with the price support, payment, and production adjustment program for wheat" (USITC 1994, p. A-3). He therefore asked the ITC to investigate the truth of this claim. In July 1994 the ITC, after hearing an interesting array of evidence (reviewed in Babula, Jabara and Reeder 1996), split 3–3 on the key issue of material interference. Three commissioners concluded that material interference occurred, and three concluded that the evidence "could support the President finding either material interference or no material interference" (USITC, p. 3). All six recommended that the president impose some additional barriers to U.S. imports of wheat from Canada.

CUSTA requires that a Section 22 import restriction must be a response to imports caused by a substantial change in either U.S. or Canadian policy. In addition, the agriculture provisions of the Uruguay Round of GATT prohibit imposition of new quantitative restrictions on agricultural imports, limiting the president's options during the 1995–2000 implementation period. However, in April 1994 the United States notified the GATT that it intended to modify wheat tariffs under GATT Article 28. The article's provisions require consultations with affected countries. In August 1994 the United States and Canada announced an agreement that U.S. imports of wheat from Canada would be limited through tariff-rate quotas to 1.5 million metric tons for the next year. In September 1995 the agreement lapsed, and there have been no further restrictions. Supply-demand forces in 1995–97 kept Canadian exports of wheat to the United States below the 1.5 million ton level.

Despite the expense and disruption caused by these and other trade disputes under CUSTA/NAFTA, it is worth noting that even in the disputed commodities, trade remains substantially more open than it was before those agreements. (In the period before 1989 wheat imports from Canada, for example, did not exceed 0.3 million metric tons.) In general, U.S. agricultural trade with Canada and Mexico has increased. The table below shows some relevant data. Both U.S. imports from and exports to Mexico have increased, notwithstanding the peso crisis at the end of 1994 when the peso depreciated by roughly one-half relative to the dollar. Similarly, trade in agricultural products increased in both directions between Canada and the United States. Some fairly crude econometric evidence, holding currency exchange rates and trend growth rates constant, suggests the increases in trade are significant and

<table>
<thead>
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<th>Table I</th>
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<tbody>
<tr>
<td><strong>U.S. Agricultural Imports and Exports under NAFTA</strong></td>
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<td>(US$ millions, except for NAFTA share in percent)</td>
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<th>IMPORTS</th>
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<th>FROM NAFTA</th>
<th>FROM NON-NAFTA</th>
<th>NAFTA SHARE</th>
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<td>2,372</td>
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<td>6,474</td>
<td>18,150</td>
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<td>1993</td>
<td>2,708</td>
<td>4,620</td>
<td>7,328</td>
<td>17,653</td>
<td>29.33</td>
<td>24,981</td>
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<tr>
<td>1994</td>
<td>2,855</td>
<td>5,231</td>
<td>8,086</td>
<td>18,732</td>
<td>30.15</td>
<td>26,818</td>
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<td>1995</td>
<td>3,780</td>
<td>5,559</td>
<td>9,339</td>
<td>20,654</td>
<td>31.14</td>
<td>29,995</td>
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<tr>
<td>1996</td>
<td>3,763</td>
<td>6,782</td>
<td>10,545</td>
<td>21,885</td>
<td>32.52</td>
<td>32,430</td>
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<th>EXPORTS</th>
<th>TO CANADA</th>
<th>TO MEXICO</th>
<th>TO NAFTA</th>
<th>TO NON-NAFTA</th>
<th>NAFTA SHARE</th>
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<tr>
<td>1990</td>
<td>4,197</td>
<td>2,553</td>
<td>6,751</td>
<td>32,612</td>
<td>17.15</td>
<td>39,363</td>
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<td>1991</td>
<td>4,554</td>
<td>2,999</td>
<td>7,553</td>
<td>31,651</td>
<td>19.27</td>
<td>39,204</td>
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<tr>
<td>1992</td>
<td>4,502</td>
<td>3,791</td>
<td>8,693</td>
<td>34,237</td>
<td>20.25</td>
<td>42,930</td>
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<td>1993</td>
<td>5,271</td>
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<td>8,874</td>
<td>33,734</td>
<td>20.83</td>
<td>42,608</td>
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<td>5,304</td>
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<td>10,017</td>
<td>35,687</td>
<td>21.92</td>
<td>45,704</td>
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<td>1995</td>
<td>5,738</td>
<td>3,519</td>
<td>9,258</td>
<td>46,556</td>
<td>16.59</td>
<td>55,814</td>
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<td>1996</td>
<td>6,145</td>
<td>5,446</td>
<td>11,591</td>
<td>49,840</td>
<td>18.87</td>
<td>61,431</td>
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</table>
are attributable to NAFTA (Tweeten, Sharples and Evers-Smith 1997; Gardner 1997).

The increase in North American market integration appears to have increased Canada's and Mexico's share of U.S. agricultural trade. The two countries' share of the value of U.S. agricultural imports increased from 25 percent in 1990 to 32 percent in 1996, and their share of U.S. agricultural export value rose from 17 percent to 23 percent over the same period. However, there has not been sufficient trade diversion to reduce U.S. agricultural trade outside of NAFTA, which remains the source of 75 percent of U.S. agricultural imports and the destination for 67 percent of U.S. exports. As Table 1 indicates (right-hand panels) trade outside NAFTA has increased even more in dollar value than NAFTA trade since 1990.

These data thus cast doubt on both hypotheses 3 and 4 above. NAFTA (which incorporates CUSTA) has led to real liberalization that has not been evaded. And intra-NAFTA trade increases do not seem to have occurred at the expense of trade between NAFTA and the rest of the world.

However, the way of CUSTA/NAFTA has not been smooth. If hypothesis 3 has failed, it is not for lack of trying by domestic interests in all three countries.

Finally, a word about hypothesis 2, which is perhaps most pertinent to the overall subject of this conference, "open regionalism." What prevents open regionalism from being an oxymoron is that regional trade agreements can in fact improve rather than detract from the prospects for liberalizing trade globally. It is the opportunities for tradeoffs among interest groups within the negotiating countries that make this so, and I believe that, in the case of U.S. agriculture at least, CUSTA/NAFTA and the Uruguay Round of GATT were mutually complementary rather than competitive; and the evidence available gives no indication that CUSTA/NAFTA has resulted in less trade between the United States and countries outside NAFTA.

References


Regional Trade Agreements: 
The Case of Agriculture

ROBERTO JUNGUI TO

THE PURPOSE OF THIS PRESENTATION IS TO DISCUSS THE PROBLEMS POSED BY MACROECONOMIC EVENTS AND MAINLY BY THE RECENT BUT PERSISTENT EXCHANGE-RATE APPRECIATION ON THE EFFORTS MADE BY LATIN AMERICAN COUNTRIES TO LIBERALIZE AGRICULTURAL TRADE AND TO ENGAGE IN REGIONAL TRADE AGREEMENTS.

From that perspective, I start with a brief retrospective view of the expectations held in the 1980s regarding the impact of import liberalization and overall structural reforms that the Latin American countries were beginning to adopt on agriculture. The second section deals with the evidence on what happened and what went right and wrong, emphasizing the impact of the exchange-rate appreciation on agriculture. The last section takes a look at what is taking place in the areas of the agriculture commitments in the Uruguay trade negotiations and the Latin American regional trade agreements, and the possible conflicts that may arise as a result of the exchange-rate appreciation process.

The Agriculture Consensus of the 1980s

Coinciding with the economic literature of the 1980s regarding the benefits of stabilization policies, trade liberalization and structural reforms, a group of outstanding economists linked to the World Bank and the International Food Policy Research Institute (IFPRI), who had been working on agricultural policies, developed what, in the words of John Williamson, could be termed their own “Washington agricultural consensus.” This term alluded to what they considered should be the agricultural policies to be adopted mainly by Latin American countries.

The consensus, supported in well-documented country and cross-section papers, published among other places, in books edited and co-authored by our roundtable colleague, Alberto Valdés, parted from the view that, in their efforts to promote industrialization, developing countries “distorted price incentives against agriculture.” As a result, agricultural output was lower than would have been the case under more neutral incentive structure (Bautista and Valdés 1993). In essence, they argued that there had been discrimination against agriculture, that industrial protection acted as a tax on agriculture, that existing policies led to overvalued exchange rates, and that policies had favored the production of agricultural importables rather than exportables (Krueger, Schiff and Valdés 1990). What is most significant from the point of view of this presentation is their hypothesis, supported by the Argentine case, that the agricultural sector would be the most benefited by the macroeconomic policies, among other factors, because the sector is particularly vulnerable to exchange-rate distortions, given that its output is highly tradable (Mundlak, Cavallo and Dome nech 1988).

Roberto Junguito is an economist, working as a full-time member of the board of the Colombian Central Bank, Banco de la República. The author acknowledges the contribution of Felipe Barrera of the IDB in the regression analysis linking structural reforms with agriculture performance in Latin America.
Incidence of Structural Reforms in the Latin American Economies

Recently, there has been an increasing academic effort, including the World Bank (1993), to assess the overall impact of the structural reforms and stabilization policies adopted by the Latin American countries in the late 1980s and early 1990s. A paper by Lora and Barrera (1997) of the IDB measured the incidence of reforms on economic growth, through a cross-sectional analysis linking growth performance to an index of structural reform policies including trade, fiscal, financial, labor and privatization measures. They attribute to reforms an additional 1.7 percent to 3.0 percent annual growth of GDP, more than half of it of a transitory nature. In terms of particular reforms, they find that trade liberalization has been the most important.

On the other hand, they also find that stabilization policies have helped to accelerate economic growth and argue that the joint effect of lower and less volatile inflation rates have added an additional 0.7 percent annual GDP growth. Using a larger sample of countries, Fernández and Montiel (1997) conclude that the positive impact of reforms in Latin America conform to the worldwide experience and attribute to stabilization policies an even higher impact on growth. They also consider that the boost on growth that the reforms have provided during the last five-year period is not of a transitory nature.

The topic of the particular impact of import liberalization and structural reforms on the agricultural sector has not been specifically addressed. In that regard, with the purpose of this round-table, Felipe Barrera, one of the co-authors of the IDB study referred to above, ran a regression model for the cross-section of Latin American countries linking agricultural sector performance measured by its GDP growth in the period 1993–95 (labeled as ZCAGRIC and WCAGRIC for the cases, respectively, of fixed and random effects) with the IDB-index of structural reforms (ZDIP5 on WDIP5), and the real exchange-rate (ZCITCR and WCITCR). The regression equation was also corrected by two variables common in the economic growth literature, namely the initial period GDP (noted as WLPERC83) and education (WSCH83).

Figure 1 illustrates a positive association between agricultural GDP growth and the country specific index of structural reforms. The regression analysis, shown in the Appendix, which assumes both fixed and random impacts on agricultural growth, confirms that there has been a positive and significant relationship between agricultural growth and the reform index. Such results back up the

![Figure 1: Association Between Agricultural GDP Growth and the Country-Specific Index of Structural Reforms](image-url)
“Washington agricultural consensus” regarding the expected incidence of import liberalization, structural reforms and stabilization on agriculture.

Another very important result that stems from the regression analysis regards the positive and significant relationship between the real exchange rate (measured in terms of local currency units per U.S. dollar) and agricultural output growth. As Table 1 shows, however, in the period under analysis, the general trend in Latin America was one of appreciation of the real exchange rate due mainly to the capital inflows that occurred in the first half of the 1990s. Therefore, it appears that in the 1990s there were conflicting signals in terms of a positive stimulus of reform policies on agricultural output growth and a negative one from the real exchange rate, and the international price trends.

From that perspective, there are two major points to be made. The first is that the direction of the real exchange rates in the Latin American countries was, ex post, the opposite of what was expected, despite the depreciation that took place in the second half of the 1980s; moreover, it acted against agriculture’s GDP growth. The second and more significant result is that the positive impact of the structural reforms overrode the negative impact due to exchange-rate appreciation. Undoubtedly, industrial protection and trade barriers were negatively affecting the Latin American agricultural sectors.

### Agriculture Trade Policies

A final item I would like to discuss is the potential impact of trade policies on agriculture. Such policies include the independent trade liberalization process discussed above, the 1994 GATT Agreement on Agriculture, and the trends toward regional trade agreements. In this context, I ask the following question: To what extent is the current trend in exchange-rate appreciation in Latin America an impediment toward agriculture trade liberalization, and do regional trade agreements represent a step toward a more protectionist environment?

As an answer to the first part of the question, there is wide recognition that Latin American nations undertook, in an independent and unilateral fashion, a process of trade liberalization, including agriculture, that preceded the 1994 GATT Uruguay Round Agreement (Valdés 1996). On the other hand, the vast literature on the subject qualifies the Agreement on Agriculture as a “historic international milestone” and as the “most sweeping attempt to

### TABLE 1

Real Exchange Rate to the U.S. Dollar*  
(1986 = 100)

<table>
<thead>
<tr>
<th>YEAR</th>
<th>VENEZUELA</th>
<th>PERU</th>
<th>ECUADOR</th>
<th>CHILE</th>
<th>BRAZIL</th>
<th>ARGENTINA</th>
<th>URUGUAY</th>
<th>MEXICO</th>
<th>COLOMBIA</th>
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<tr>
<td>1980</td>
<td>76.41</td>
<td>93.01</td>
<td>64.18</td>
<td>47.73</td>
<td>68.53</td>
<td>37.73</td>
<td>50.39</td>
<td>57.14</td>
<td>59.72</td>
</tr>
<tr>
<td>1981</td>
<td>72.59</td>
<td>85.40</td>
<td>60.81</td>
<td>43.89</td>
<td>64.38</td>
<td>45.74</td>
<td>49.23</td>
<td>52.62</td>
<td>59.57</td>
</tr>
<tr>
<td>1982</td>
<td>70.28</td>
<td>90.25</td>
<td>65.24</td>
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* The CPI is used domestically and internationally.

** For Venezuela, Argentina and Uruguay, refers to the average up to November; Brazil up to October.

liberalize agriculture" (FAO-World Bank 1996). More recently, the concerns have turned toward regional trade agreements and open regionalism, the subject matter of this World Bank Annual Conference.

However, even though the surveillance of price and trade policies (Valdés 1996) signals that trade liberalization in the agricultural sector in Latin America led to the elimination of most quota restrictions, the removal of export taxes, the reduction of the role of state trading agencies and a unilateral process of tariffication, the results also show that the trade liberalization process also coincided with a period of decline in real domestic farm prices due mainly to the exchange-rate appreciation that occurred during the early 1990s.

By the same token, in a seminar with wider geographical spectrum sponsored by the IMF, Wong and Kirmani (1997), dealing with trade policy issues, specifically pointed out that "the evidence from a number of developing countries and transition economies was that the real exchange-rate appreciation, brought about by large capital inflows or other reasons, could adversely affect the authorities' efforts to pursue further trade liberalization or might even cause partial reversal in such liberalization." In that sense, an article by Kirmani, Papageorgiou and Michaely (1997) argued that exchange and trade restrictions often act as substitutes, although he rightly indicated that exchange-rate appreciation should be tackled by monetary and fiscal policies. The point that should be explained is whether some of the trends in agricultural regional integration efforts could evidence elements of protectionist nature used as a compensation to the exchange-rate appreciation process.

The growing literature on the subject suggests that regionalism could be looked at as a supplement to multilateralism, as an alternative to it, or as a path toward it (Corden 1997). In that regard, pointing to the agricultural sector, Robert and Schiff (1997) argue that the impact of regional agreements on welfare could be ambiguous, while the impact of the Uruguay Agreement on Agriculture is positive, thus suggesting that regional agreements should conform to GATT. Analyzing from the Brazilian perspective the case of agriculture in Mercosur, Salazar-Brandao, Rezende-López and Pereira (1997) emphasize the importance of regional trade agreements and argue that Mercosur was built on the principle that less protection and increased competition have favorable welfare effects on the domestic economy. In the same vein it is argued, from the Argentine perspective, that Mercosur represents a transitional phase toward a complete insertion into the international markets (SAGYP 1995). It appears, at least formally, that the agricultural trade component of Mercosur is not directed to introduce protectionism as a result of the real exchange-rate events.

Such a situation represents a contrast to the tendency shown by the Andean countries. As Valdés (1997) argues, countries such as Colombia and Venezuela could be tempted to adopt protectionist policies toward agriculture. In fact, it has been shown that Colombia bounded tariffs at "excessively high levels" representing a case of dirty tariffication at the GATT level (Valdés and McCalla 1996). Besides, it has adopted a prior license system-clearances by the Ministry of Agriculture. The clearest expression of the Andean Group's trends toward the protection of agriculture is the existence of a price band system, originally adopted by Colombia and extended to the group, and the increase in measures of aggregate support relative to the value of production by its member countries during the first half of the 1990s (GRAN 1997). Such policies at least coincided with the real exchange-rate appreciation and with the increasing complaints by agricultural sector representatives regarding the negative incidence of macroeconomic policies on the agricultural sectors of the member countries.

Conclusions

This comment has aimed at discussing the importance of trade liberalization and structural reforms on the agricultural sector performance of Latin American countries. The comments also point out the risks imposed by the process of real exchange-rate appreciation on the efforts to pursue further liberalization. It formulates the hypothesis that regional trade agreements could be used as vehicles for protectionism, as the Andean Group decisions seem to suggest.

References


## Appendix

**DEPENDENT VARIABLE ZCAGRIC - ESTIMATION BY LEAST SQUARES**

Panel (4) of Annual Data From 1/1992:01 To 19/1995:01

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**LINREG WCAGRIC**

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**DEPENDENT VARIABLE WCAGRIC - ESTIMATION BY LEAST SQUARES**

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Regional Trade Agreements: The Case of Agriculture

ALBERTO VALDÉS

The proliferation of free-trade agreements (FTAs) in Latin America and the Caribbean during the 1990s is remarkable. Unilateral trade liberalization processes within individual Latin American countries created a new economic environment that fostered the emergence of Mercosur, NAFTA and a number of bilateral and trilateral agreements, while bringing life to otherwise sleepy legal agreements such as the Andean Group and the Central American Common Market. These new FTAs have proven far more significant than previous arrangements. The perceived costs of remaining excluded from these free-trade agreements has sustained the trend's momentum, influencing more countries to join.

Unlike previous trade-agreement initiatives in the 1960s and 1970s such as LAFTA, EFTA, ASEAN in Asia, and a number of others, agriculture is an integral part of these new FTAs. Two factors facilitated incorporating agriculture as part of the agreements in Latin America:

- Agricultural trade reform took place within a larger context of unilateral economic reform that included trade liberalization, deregulation and privatization—with no particular emphasis placed on any given sector.
- Uruguay Round commitments involving the bindings of tariffs, restrictions on export subsidies, the removal of widely used quota restrictions, and the virtual elimination of state trading throughout the region served to circumscribe policy options and reduce the likelihood that agricultural price support measures would be reintroduced.

Compared with the 50 years that preceded the current period, the prevailing economic environment in Latin America today is much more strongly oriented toward an efficient regional integration vis-à-vis the rest of the world, reflecting the understanding among policymakers that the long-term growth potential of agricultural export markets abroad far exceeds that of markets within the region. Inward-looking FTAs would impose high domestic welfare costs on their member countries by diverting trade, significantly reducing potential agricultural growth.

An optimistic view of trade liberalization holds that rather than limiting the openness of FTAs to non-members, these free-trade agreements will accelerate Latin America's integration into the rest of the world, preparing member countries for competition from NAFTA and elsewhere through regionally—and subregionally—coordinated improvements in infrastructure, telecommunications, technical standards, sanitary and phytosanitary measures, customs administration and financial services, in addition to the tariff reductions that have already taken place unilaterally.

The experience of Mercosur's associate members, which are not subject to Mercosur's common external tariff—namely, Chile and Bolivia (and Peru, which applied for membership in 1997)—and the Canada-Chile free-trade agreement are recent developments well worth monitoring.
as they incorporate innovative approaches and may come to be extended to more countries in the region.

Selected Issues of Implementation

There are several sensitive issues of implementation that require coordinated action among members of FTAs. For this panel, I have elected to highlight six of them: dispute resolution, harmonization of national standards, rules of origin, dealing with exceptions and tariff escalation, the exchange rate policies, and the non-tariff agenda.

Dispute Resolution

How expeditiously and objectively do Mercosur, the Andean Group, NAFTA and the Central American market handle disputes among their members? Are most disputes resolved on a technical basis, or do they resort instead to political negotiations? Do these FTAs have a politically neutral and regional (rather than bilateral) body to deal with trade disputes? The absence of an effective and credible system for settlement of disputes would hinder the process of integration.

Disputes among member countries of Mercosur so far appear to be resolved at the political level, which, one would reasonably expect, works to the disadvantage of smaller economies. The same tendency is evident within the Andean Group. NAFTA, which is reputed to have the most developed legal framework for dispute resolution in the hemisphere, and which allows member countries to choose between regional and multilateral forums, should eventually provide valuable insights.

Harmonization of National Standards

FTA trade in primary and processed agricultural products, and on perishables in particular, is very sensitive to national differences in technical standards, sanitary and phytosanitary measures, and customs formalities. And red tape on imports from other member countries, such as those within Mercosur, remains heavy in a number of countries.

The question of how to facilitate progress in harmonizing national regulations leads to a number of possible measures. One is the establishment of a secretariat to design and implement common rules and standards between members. Another would be a system of mutual recognition of one another’s regulations and standards, which is less threatening to members’ policymaking autonomy. Whichever course is followed, World Trade Organization guidelines and the Codex Alimentarius for sanitary and phytosanitary regulations would serve to promote the harmonization of national standards.

Rules of Origin

The monitoring of how rules of origin are applied is a complex administrative issue for homogeneous products (commodities) in general, which is the case of many agricultural products and which requires some administration in common. Under a customs union such as the one within Mercosur, rules of origin, in principle, is not an issue and thus it does not require an administration. The incorporation of "associated states" that are not subject to the common external tariff (such as Chile and Bolivia in Mercosur, and perhaps Peru in the near future) does require monitoring, which can be done at lower administrative cost by a central agency, but this is not necessarily specific to agriculture.

Dealing with Exceptions and Tariff Escalation

The current FTAs include several exceptions, such as sugar in Mercosur, maize and beans in Central America, products under the price-band scheme in the Colombia-Chile Agreement, and some others. There is furthermore a significant degree of tariff escalation at higher levels of processing, with the end result that effective rates of protection on semi-processed and processed goods, both with regard to member and non-member countries, are higher than the nominal tariffs on those products.

Exchange-Rate Policies

In the past, developments on the foreign exchange markets in this region have been an influential factor on the pressures for higher agricultural protection. Continuous appreciation (i.e., fall of the real exchange rate) is already a source of tension among members of some FTAs. The significant appreciation of the local currency observed during these last three to five years in Colombia, El Salvador, Brazil and Chile (and until a few years ago in Peru and Argentina) has induced a reduction in "real" domestic farm prices, generating strong resistance to further agricultural trade liberalization in these countries (Valdés 1996). Within Mercosur, changes in the Brazilian-Argentine bilateral exchange rate have been recognized as a strong force in redirecting trade flows of farm products between these two countries.
The Non-Tariff Agenda

Under the new regime based on tariffs prevailing in agriculture in this region, countries may be expected to turn increasingly to a nontariff agenda, such as sanitary and phytosanitary measures and technical standards. This could be a particularly complex challenge in the integration process. The evidence presently available is too sketchy to enable assessment of whether, where, or to what extent this is happening, but it warrants careful monitoring.

Is a common agricultural policy necessary for an efficient customs union? Unlike the European Union, Mercosur and the Andean Group do not have a common agricultural policy, and in this author’s opinion, they should not. A “good” common policy is of course a good cause. However, considerations of political economy are always important, and to give agriculture, or any other sector, a special standing and its own bureaucracy is likely to make subsequent reforms more difficult even when circumstances change. Administrators of such bureaucracies are likely to become captives of producers’ lobbies, pressured to introduce or maintain subsidies and protection. Hopefully Montevideo will not become the Brussels of Mercosur.

However, while not necessarily requiring a common agricultural policy, the six issues highlighted above do require a coordinated action and close monitoring. How is the current coordination system working, and which institutional set-up is most effective in guarding the interests of consumers as well as producers? These are increasingly complex issues that continue to unfold over time.

Price Stabilization Policy: A Contentious Issue

By 1993 most countries in Latin America had implemented bold programs of unilateral trade liberalization, eliminating most quantitative restrictions on agricultural imports, removing taxes, quotas and licenses on exports and dramatically reducing or eliminating state trading in agricultural trade.

In their commitments under the Uruguay Round Agreement (URA), the overwhelming majority of Latin American countries adopted the “ceiling bindings” modality, in which a ceiling binding was proposed for previously unbound tariffs. By 1995 all agricultural tariffs in the 17 Latin American countries examined by Carson (1997) were bound under the URA, while proper tariffing under the URA took place in only seven of those countries, with most of the tariff quotas introduced in only two countries.

An important implication of this is that under the URA, less than 20 percent of agricultural products were tariffed (the rest are covered by ceiling bindings) and thus have no recourse to the “special safeguard” provision on agricultural imports. These countries received no credit for having converted to tariffs before the URA.

Limited to applying quantitative restrictions and unable to use the special safeguard provision, one indirect method of protection becoming common in the region is the fluctuating tariff that is applied as part of price-stabilization schemes, such as price bands in the Andean Group and in Chile, and surcharges in Peru. Under the new rules and commitments accepted in the URA, price bands are legal only when the sum of the basic tariff and the surcharge does not exceed the bound tariff level, and it is not linked to any internal reference price. However, given that the specific duty is charged to the CIF (cost-insurance-freight) price of each shipment, it is likely that imports from different countries will be charged different tariffs, amounting to discriminatory treatment among different foreign suppliers (Cordeu, Valdés and Silva 1997).

This variable import-tariff scheme is a contentious international trade issue, and potential legal problems loom on the horizon. Furthermore, within Latin America, products covered under such schemes have generally been given special treatment, including exempted, or slower tariff reductions under bilateral agreements (such as those between Colombia, Venezuela and Mexico, and between Colombia and Chile). Hopefully, the next round of multilateral negotiations will consider extending the special safeguard provision to these countries in exchange for the removal of fluctuating tariff schemes.

The Importance of Infrastructure Development for Regional Integration of Agriculture

Particularly in South America, transport costs usually represent a high share of the CIF value of agricultural products. Mercosur is giving a great impetus to coordinated efforts by both public and private investment in roads, ports and railways. These efforts should significantly reduce transport costs and thus contribute to further integration in agricultural markets among Mercosur members. Elsewhere in South America, particularly in the Andean region, the magnitude of the resources needed to improve
transport and communications is enormous and likely to remain a substantial bottleneck for further integration.

**Concluding Remarks: The Slower Pace of Trade Liberalization in Agriculture**

As elsewhere in the world, trade liberalization and integration of agriculture in Latin America advances at a slower pace than that of most other tradable sectors. However, Mercosur has not applied high levels of protection against agricultural imports from non-member countries, maintaining with few exceptions a tariff range of 10 to 20 percent. Unfortunately, the same cannot be said of the three remaining members of the Andean Group (Colombia, Ecuador and Venezuela), which maintain a controversial price stabilization scheme with a strong protection effect on eight agricultural products (and on most of its substitutes and complements, covering more than 100 items). Some backsliding is evident, such as the effect of “convenios de absorción” in Colombia, and the recent increase in surcharges in Peru.

**References**


**Note**

1. Starting in 1994, the Andean Group adopted a common external tariff but limited it to Colombia, Ecuador and Venezuela.
VIII. Infrastructure and Integration
Promoting Latin American Trade: The Role of Infrastructure

SRI-RAM AIYER
HANS J. PETERS

At the outset of the 1980s the value of Latin America's foreign trade reached a level just above US$200 billion, with no major increments during most of that decade. The scenario changed dramatically in the early 1990s when substantial advances in the region's annual trade performance materialized. Between 1992 and 1996 Latin America's annual foreign trade transactions increased 58 percent from US$315 billion to almost US$495 billion. While exports exceeded imports significantly in 1992, the 1996 trade data reveal that, for the region as a whole, the value of exports was only marginally higher than the value of imports during that year. Most of Latin America's countries experienced trade deficits. In 1996 Brazil had the highest deficit—US$4.5 billion—but other countries, like Colombia and Peru, also showed significant shortfalls. Yet due to huge surpluses in Mexico and Venezuela, Latin America's total trade ended on the plus side.

Latin America's Trade within a Changing Competitive Environment

The region's main sources of imports and destinations for exports are the United States (46 percent of total foreign trade in 1996), the markets of the European Union (19 percent), Japan, and the "Asian Tiger" countries (13 percent). The most noteworthy development relates to the explosive growth of intra-regional trade among the Latin American nations, which increased from US$60 billion in 1992 to US$110 billion in 1996—almost 17 percent per year on average. By comparison, the overall annual growth rate of the region's foreign trade was 12 percent during the same period.

In spite of these impressive growth trends, Latin America's share in world trade was low—barely 5 percent in 1996. With a few exceptions most regional economies still rely on their traditional export commodities—essentially raw materials and semi-processed goods. But the international markets for these commodities have been volatile as demand patterns have changed. Only in a limited number of Latin America's economies has trade growth been spurred by export diversification. In many instances the share of manufactured goods in total annual merchandise exports has remained modest (see Table 1). The World Bank's 1997 assessment of global economic prospects concluded that the share of technologically advanced goods in Latin America's total exports is still insignificant when compared, for instance, with the performance of Asia's industrializing economies.

With growing incomes in the regional economies, it can be expected that the demand for imported goods will continue the growth trend that has been apparent since the early 1990s. By implication there is an inherent danger of
TRADE: TOWARDS OPEN REGIONALISM

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<td>310</td>
<td>817</td>
<td>12</td>
</tr>
<tr>
<td>Peru</td>
<td>3,900</td>
<td>5,575</td>
<td>18</td>
</tr>
<tr>
<td>Uruguay</td>
<td>1,060</td>
<td>2,106</td>
<td>38</td>
</tr>
<tr>
<td>Venezuela</td>
<td>19,221</td>
<td>18,547</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: World Development Indicators 1997 (The World Bank)

widening gaps between annual imports and exports. To avoid the build-up of sizable trade deficits, focus will have to be on efforts to increase exports. But continued reliance by the Latin American countries on traditional export commodities is unlikely to achieve such objectives—even if the quality and prices of locally produced goods are compatible with or superior to those of the international competition. Although quality and price are still important criteria for success in trading, competitive practice in today’s markets has established even more stringent determinants of competitiveness (see Box 1).

The challenge for the governments and business communities all over Latin America will be to adjust to the changing practices in international trading. This observation gains special importance in view of the fact that more than 70 percent of regionally produced export commodities are targeted at markets in the OECD countries. It is in these countries where evolving commercial practices in manufacturing and trading have had profound effects on industrial relations and purchasing behavior.

These new commercial practices are, above all, critically dependent on the availability of efficient trade-supporting infrastructure and services. The physical characteristics of these support networks and their organization are in many ways radically different from traditional structures and practices that are still prevalent throughout Latin America. It is therefore of prime importance for regional governments and the local business communities to take decisive steps to establish infrastructure systems and service provisions that are conducive to improving trade performance.

The Elements of Changing Competitive Practice

There has been growing evidence of fundamental ongoing changes in the organization and management of industrial and marketing processes throughout the world economy. These developments gained momentum during the 1970s. Since then major breakthroughs in communication and transport technologies materialized. Much of the innovation of the past 20 years has been directed, implicitly or explicitly, at the very task of shrinking distance. The continuing transport and communications revolution has brought about an enormous reduction in distance as a natural barrier to trade and investment. Technological change has intensified the pressures of international competition. Combined with deregulation in the transport and communications sectors, it has led to substantially lower costs and improved quality of these services. In virtually all cases, competition and deregulation of entry barriers have been a key factor driving down prices, raising the quality of transport and communication services internationally and
INFRASTRUCTURE AND INTEGRATION

The Changing Determinants of Competitive Success

New information technologies are transforming the way sellers sell and buyers buy. As a result, traditional marketing strategies are steadily becoming less productive and cost-effective.

Increasing customer sophistication is changing the very nature of customer-vendor relationships. Customers are demanding responsive, consultative, value-added partnerships, while eschewing conventional, transactional relationships.

Innovative manufacturing and distribution strategies, electronic data interchange and system solutions will continue to evolve, altering the way goods are purchased. Buyers will reduce the number of approved vendors while demanding longer-lived contracts, shorter order cycles and more responsive service.

The competitive environment is becoming increasingly more fluid in response to productivity pressures, new global competitors and evolving corporate strategies.

Changing marketing strategies are forcing sales organizations to refocus resources dynamically, set new priorities, sell new products and meet the demands of unfamiliar markets.

Market evolution is forcing sales organizations to focus their ever scarcer resources on more selectively chosen, high potential customer segments.

nationallly, and spreading access to services—in many instances playing a larger role than technological advances alone.

Among the major consequences, lower transport costs have extended the reach of global production to labor-intensive manufacturing, allowing the dispersion of production stages over much longer distances, even for products with low value-added margins. Communications improvements have simultaneously extended the scope of global production to more technologically complex, information-intensive and time-sensitive products and services by permitting better information flow, monitoring and coordination. It became possible to monitor all phases of moving a product from its raw material source through every intermediate processing stage to the consumer. Such close monitoring revealed major inefficiencies in the traditional set-up of materials acquisition, production and distribution to the end markets. Particularly evident were the high costs of associated inventory holdings. Parallel to these developments, market demand had started to shift much more rapidly than during any time before. Better information available to the consumer through improved information networks was a key reason. As consumers move faster between suppliers and product lines, there is more need for businesses to anticipate quickly and correctly what will be demanded, and to put into place a foundation for manufacture and delivery of products that can be shifted economically and quickly as tastes change (see Box 2).

Manufacturers and traders in the industrialized countries were confronted with the high costs inherent in their traditional business organizations and at the same time with increasingly volatile market demand. The need to

The Growing Importance of Customer Service

Current and future markets will achieve competitive differentiation by adding value through service, focused on achieving customer goals. Customers are both end users and industrial clients. Service has become an essential tool for differentiating companies in the marketplace. Service has become as important as—and in some industries even more important than—the main line of products made and sold. The main point of today’s focus on service is to build—or maybe in some cases rebuild—such strong relationships with customers that they will be extremely reluctant to buy from competitors, even if they think that the competitors’ products will be better. To make this kind of performance a reality, business managers have to go well beyond the transaction-oriented, cost-conscious, inward-looking practices of the past. They must realize that customer-driven marketing and distribution is the foundation of a new approach and philosophy that separates winners from losers. There has to be a shift from transaction-oriented to process-oriented management. What is really needed is competitive advantage that distinguishes a supplier from all competitors that a customer could buy from. Today and into the 21st century that advantage is likely to come only from value-added customer service.
reduce costs and to become more responsive to changing customer preferences forced these enterprises to engage in substantial restructuring of their corporate practices. Rising factor costs in their domestic markets induced outsourcing of intermediate production processes to offshore industries in countries with abundant low-wage labor and other conditions of comparative advantage (see Figure 1). Traders also started to explore less costly supply sources. Growth in global production is deepening the economic integration of countries. International outsourcing of production inputs is gaining strength. Because of greater competition, firms in industrialized countries are being forced to take advantage of lower-cost production opportunities around the world, to disaggregate production processes, especially in manufacturing, into stages that are outsourced to different countries according to their comparative advantage. This process which has been described as a “slicing up of the value change,” is an increasingly important aspect of global production today.

These developments seemed to open prospective market opportunities for aspiring industries in developing countries and held the promise of accelerating local economic growth. Businesses in a number of developing economies—notably those along Asia’s Pacific rim—have been able to capture these new opportunities and are now active participants in the global manufacturing and trading networks (see Box 3). A key element behind such success was competition. As it turned out, two main forces underlie the increased intensity of competition: greatly reduced barriers to trade and investment in these countries, and the falling costs of international communications and transport.

Global sourcing is not an exercise in finding cheap sources of supply or suppliers of questionable quality in the backwaters of the world, however. It is a process that companies use to select the suppliers that offer the best value. The promise of these prospects is dampened for many countries in Latin America by the apparent inability of their public administrations and commercial communities to effectively address the ever more stringent requirements of foreign businesses for reliable deliveries in increasingly shorter time intervals, and with low reject rates. The difficulties encountered in these countries are a reflection of not being able to grasp and thus to internalize the consequences of technological progress and increasingly volatile market behavior. What appears to be particularly cumbersome to adjust to are the strategies adopted by the international service industries in reaction to changing global practices in manufacturing and trading. A greater traditional inward orientation in Latin America until recently provided foreign affiliates with strong incentives for domestic production and consumption, whereas in more output-oriented East Asia, export propensities were high and rising.

As considerations of economic efficiency and international competitiveness have gained importance, the role and priorities of governments have been called into question, and the need for new forms of regulations has become apparent. In most industrialized countries, technological progress and greater competitiveness have been the cause and effect of a trend toward deregulation and simplification, as well as updating the regulatory machinery, in turn enabling a more flexible and adaptable integration of services into productive functions. With the growing complexity of service activities, the role played by governments as providers of basic services is shrinking. Their place is being taken by private agents. In this new context govern-
BOX 4

Global Market Connections: How Asian Manufacturers Succeeded

**Textile Trade:** Great Future Textiles Ltd. of Taipei is a vertically integrated textile and garment manufacturer and exporter. The company is a key supplier of finished garments to Modern Fashions GmbH in Düsseldorf (Germany). While fashion designs are handled in the Taipei headquarters, tailoring takes place in a recently established offshore manufacturing base in Thonburi, just north of Bangkok (Thailand). The new factory imports high-quality designer textile from a weaver in Rajastan (India) and cotton from the U.S. Gulf region (Texas). Synthetic yarn is supplied from a chemical industry complex in Java (Indonesia). The final products are air-shipped from Bangkok to Düsseldorf. In all this, Great Future has to be very responsive to Modern Fashion’s “Quick Response” strategy, which allows the German retailer to adjust continuously to changing market demand.

**Plastics Trade:** Infantland Stores Inc. of Cincinnati, Ohio (United States) purchases large amounts of plastic toys from Fortune 21 Ltd. in Hong Kong, China. Fortune 21 produces these toys in Jiangmen (China) under a joint venture arrangement with a local manufacturer. Fortune buys plastic resin from Downstream Petroleum Exports Sdn Bhd in Johore (Malaysia) which is then shipped via Singapore and Hong Kong to the Jiangmen plant. Infantland buys Fortune’s plastic toys FOB ex-Jiangmen and arranges for transport through Hong Kong and Long Beach, California, and hence via the U.S. rail-based land bridge to its home base in Ohio. All transactions are done on a “just-in-time” basis, which allows Infantland to organize its retailing activities with minimal inventories.

**Food Trade:** Siam Mills Co. Ltd. is a rice processing enterprise in up-country Thailand that has been successful in expanding its business volume in less than 10 years from being a supplier of a limited regional market segment to becoming a principal supplier of the North American market. Key to this success was Siam Mills’ strategy to assume full responsibility for order processing and inventory positioning on behalf of its customers, a few large supermarket chains in the United States. Siam Mills packs rice, ready for retail shelves, in accordance with the special requirements of each chain and consolidates shipments to regional warehouses for distribution in each North American subregion. The benefit for Siam Mills’ U.S. customers was practical elimination of labor-intensive, and therefore costly, packing and warehousing operations.

ments retain the important role of regulators, ensuring the sound operation of markets and protection of consumers. This development is transforming the relations between the suppliers and users of services.

Much more explicitly than in the past, industrial success and trade competitiveness depend on the highly efficient provision of supporting services and infrastructure. But it is important to note that the dimensions of services and infrastructure have changed significantly. Transportation and communications infrastructure have traditionally been thought of as physical systems that move goods or information from one point to another. By virtue of breakthroughs in technology, services and government regulations, a new generation of infrastructure has begun to emerge (see Box 4), which should be thought of not only in terms of physical systems, but also in terms of the value-added services and regulatory as well as institutional requirements that enable these systems to achieve their potential effectiveness. This new infrastructure is so significant that it is reshaping many industries and presents profound implications for entire economies. After bringing about major benefits in the industrialized countries, the new generation of infrastructure was found to have had important effects on the trade performance of East Asia’s economies. The demand of certain markets and of globally integrated manufacturing networks are increasingly requiring the location of all their operations to be tied into the global networks of this new infrastructure. Wage differential and previously important location criteria seem to have become relatively less important in determining a country’s competitiveness.

As the Asian examples show, innovations in business practice are becoming more pervasive and universal, and thus have the potential of dictating much of the future pace
The New Dimensions of Trade-Supporting Infrastructure

Changing international practices in manufacturing and trading have entailed a different demand for supporting infrastructure. The new generation of infrastructure covers a wide spectrum of technology enhancements and specific applications related to transport and communications. These breakthroughs have been referred to as "Advanced Infrastructure," or AI (Mody, Ashoka, Reinfeld 1995). To be specific, AI combines basic transportation and communications technology with information technology, thereby creating an enhanced service capability.

Other than technology enhancements, a key distinction between AI and basic infrastructure is the increased importance of value-added services associated with AI. The idea is that service providers, as well as the services themselves, are actually a part of infrastructure, which is very different from the physical way infrastructure has ordinarily been characterized. Whereas basic infrastructure is primarily supply-oriented, AI must be examined from the demand side by including considerations of design and applications that are tailored to meet the needs of specific users.

This new dimension of service—the value that it adds—not only expands the definition of infrastructure, but also makes it more important to create an appropriate environment in terms of policies, standards and resources, in which to develop AI. Without this kind of complementary support, the effectiveness of AI is simply lost. In fact, in industrialized countries, it was only after major policy reforms were introduced and the service sector became more developed and prominent that these AI systems first occurred.

The new generation of AI has had profound effects on the economics of manufacturing industries in industrialized countries. Increasingly, AI has important consequences for the Latin American countries as well. While traditional considerations such as costs of labor, utilities and space remain important, regional manufacturers must also have access to global networks in communications and transportation in order to meet the competitive demands in modern business environments. The premise is that if the regional economies do not develop AI, they will gradually lose their competitive edge and run the danger of experiencing declines in their manufacturing industries.

Merely having adequate physical infrastructure, such as ports, roads and telephones will not be sufficient to promote the activities that growing economies need. This physical infrastructure will have to be enhanced with technology and applications (i.e., AI) that allow firms to meet the competitive demands for shortened product cycle times and improved customer service.

The inclusion of value-added services as part of AI means that governments need to change how they plan and administer this sector. To create an effective AI, they must not only plan the physical infrastructure, but must also create the appropriate environment in which the facilities and the service providers will operate. Governments must recognize that availability of AI is becoming extremely critical to firms if they plan to compete in the global marketplace. This new generation of infrastructure depends to a great deal on the freedom and flexibility of service providers and users of this infrastructure.

drivers that affect market behavior and determine international competitiveness in the world economy.

Because a large share of exports from developing countries is targeted at markets in the OECD economies, a principal World Bank investigation concentrated on industrial and trading practices, as well as consumer behavior in the OECD markets. Through an extended cooperative network with professional and commercial organizations in several countries, it was possible to survey
almost 1,500 businesses involved in manufacturing, trading and the provision of supporting services—such as informatics, transport and warehousing—in three areas that are important in this context: Japan, North America and Western Europe.

The key finding was that—ubiquitously—the strategic tools used to become more responsive to volatile market demand and to cut business costs implied a new management approach. This approach aims to orchestrate the functions of materials acquisition, production and marketing. It is called logistics management (Box 5). The principal task of effective logistics-management organizations is to reduce inventories to the lowest possible levels through streamlined supply and distribution channels. To be effective, logistics management critically depends upon advanced infrastructure and information technology. Advanced infrastructure, information technology and logistics management may be thought of as three perspectives of an enhanced business environment that is enabling a modern economy to operate more efficiently. Advanced infrastructure refers to that segment of public infrastructure—in particular transport and telecommunications—that encompasses hardware, software and services that allow users to move goods and information more rapidly and reliably. Information technology refers to that set of technologies (hardware and software) that relate to the storage, processing and transfer of information. Logistics management refers to business administration techniques, in terms of systems and approaches, that allow a firm to

**FIGURE 2**

**Logistics Cost Components**

OECD Industry Averages

![Logistics Cost Components Graph](image)

*Source: Bundesverenigung Logistik (Germany)*

**BOX 5**

**What is Logistics Management?**

The U.S. Council of Logistics Management defines logistics as “the process of planning, implementing and controlling the efficient flow and storage of goods, services and related information from point of origin to point of consumption for the purpose of conforming to customer requirements.”

optimize the flows of goods and information that apply to their operations.

The survey confirmed that the costs of excessive inventory holdings have been identified as the heaviest burden on corporate performance (see Figure 2). The application of logistics-management principles has enabled many industries and trading organizations to conduct their business with inventories that now often represent less than one week of supplies required for manufacturing or retailing. Purchasing and selling under “just-in-time,” “constraint replenishment” or “quick response” arrangements are gaining decisive importance for efficient inventory management (see Figure 3), and—more importantly—for competitive success.

These achievements have had remarkable effects on product costs. Expenditures incurred in managing logistics organizations amounted on average to 23 percent of value added and 70 percent of the operating margins in all industries that were surveyed (see Box 6). Through dedicated efforts in many industries, the logistics cost share—essentially reflecting transport intensity and the level of inventory holdings—in product final prices could be reduced to around 20 percent on average (see Figure 4). Companies that were successful in streamlining their logistics-management organizations reported that a 1 percent reduction in their logistics costs had the same effect on corporate performance as a 10 percent increase in annual sales. In the countries of Latin America the incidence of logistics costs in the market price of domestically manufactured products typically ranges between 30 percent and 40 percent. A recent investigation by the University of Costa Rica provides telling evidence.

The World Bank’s international survey revealed that success did materialize through far-reaching reorganization of corporate structures, and a substantial development of strategic alliances with service providers (see Figure 5). Many industries and trading enterprises have externalized all activities that are not core to their basic mission, which is production or selling. As a result, transport, warehousing and communication services are increasingly provided by third parties. Progressive companies also consider outsourcing equipment and private fleets because of their cap-

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**FIGURE 3**

Application of “Just-in-Time” Concepts in Purchasing and Distribution

Observed Averages by Category of Industry in North America and Western Europe

![Diagram showing observed averages by category of industry in North America and Western Europe for 1987, 1990, and 1995.](image-url)
The level and structure of logistics costs vary by industry. Although imperfect in its measurement, the concept of value added is roughly equivalent to controllable costs. As a proportion of value added, the logistics effort in North American industries ranged between 8 percent and 43 percent in selected industries in the early 1990s. Logistics costs represented, on average, 23 percent of value added. Perhaps more importantly, the average logistics costs were equivalent to 70 percent of typical operating margins. By implication a 10 percent reduction in logistics costs would yield an improvement of 7 percent in operating margins.

<table>
<thead>
<tr>
<th>TYPE OF INDUSTRY</th>
<th>PERCENT VALUE ADDED TO VALUE OF SHIPMENTS</th>
<th>TYPICAL OPERATING MARGIN</th>
<th>VALUE ADDED</th>
<th>OPERATING MARGIN</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appliances</td>
<td>49</td>
<td>11</td>
<td>17</td>
<td>75</td>
</tr>
<tr>
<td>Apparel</td>
<td>49</td>
<td>12</td>
<td>8</td>
<td>95</td>
</tr>
<tr>
<td>Automotive</td>
<td>38</td>
<td>8</td>
<td>20</td>
<td>48</td>
</tr>
<tr>
<td>Building Materials</td>
<td>34</td>
<td>12</td>
<td>33</td>
<td>48</td>
</tr>
<tr>
<td>Chemical</td>
<td>48</td>
<td>18</td>
<td>39</td>
<td>48</td>
</tr>
<tr>
<td>Electrical</td>
<td>57</td>
<td>14</td>
<td>10</td>
<td>42</td>
</tr>
<tr>
<td>Metal</td>
<td>51</td>
<td>10</td>
<td>18</td>
<td>89</td>
</tr>
<tr>
<td>Food</td>
<td>29</td>
<td>6</td>
<td>8</td>
<td>67</td>
</tr>
<tr>
<td>Furniture</td>
<td>52</td>
<td>9</td>
<td>136</td>
<td>117</td>
</tr>
<tr>
<td>Lumber</td>
<td>41</td>
<td>14</td>
<td>26</td>
<td>76</td>
</tr>
<tr>
<td>Mechanical</td>
<td>55</td>
<td>15</td>
<td>12</td>
<td>43</td>
</tr>
<tr>
<td>Paper</td>
<td>43</td>
<td>14</td>
<td>30</td>
<td>92</td>
</tr>
<tr>
<td>Petroleum</td>
<td>41</td>
<td>17</td>
<td>17</td>
<td>86</td>
</tr>
<tr>
<td>Pharmaceutical</td>
<td>41</td>
<td>18</td>
<td>33</td>
<td>42</td>
</tr>
<tr>
<td>Rubber</td>
<td>50</td>
<td>9</td>
<td>11</td>
<td>61</td>
</tr>
<tr>
<td>Textile</td>
<td>40</td>
<td>10</td>
<td>10</td>
<td>40</td>
</tr>
<tr>
<td>Tobacco</td>
<td>41</td>
<td>12</td>
<td>9</td>
<td>21</td>
</tr>
<tr>
<td>Average, All Industries</td>
<td>43</td>
<td>14</td>
<td>23</td>
<td>70</td>
</tr>
</tbody>
</table>

Source: Council of Logistics Management (United States)

An essential point to note is the context of outsourcing with respect to the provision of services (Figure 5) but also as regards the purchase of inputs to production (Figure 1) is the trend toward concentrating on a limited number of business partners. The old adage of "zero-sum game" has yielded to corporate strategies that center on strategic long-term alliances with only a few carefully selected producers or service suppliers under which each partner assumes clearly defined responsibilities, thus sharing risks. The importance of it all is that dependability and ability to provide highly efficient contributions to the joint undertaking has become a cornerstone of success—and advanced infrastructure plays a crucial role in this.
The survey findings largely confirmed that the provision of efficient supporting services had become possible through unprecedented advances in transport and cargo handling technologies. The focus within the transportation function has shifted from efficiency and cost-effectiveness to measurement of on-time delivery, order fill rates and order cycle times. Furthermore, there was clear evidence that effective communication links are prerequisite for the success of any logistics-management system. Recent World Bank investigations revealed how new information technologies have rendered many services increasingly tradable. These developments have been instrumental in enhancing two new dimensions of services: first, the proper integration and utilization of modern and efficient logistics organizations in the production process, and, second, logistics services as an important source of value added. Shippers increasingly select service providers that offer most value added over and above their traditional activities. An important value-added service in transport and warehousing is the facility to electronically track shipments real time. Order processing and assembly are other value-added services in these two industries that are attractive to shippers.

In some countries, liberalization of government regulations, basically by removing infrastructure and service barriers to efficient competition in the transport and telecommunications sectors, provided facilitation. The net result of a more open political environment was the creation of greater opportunity for logistics to take an active role in competitive practice. In short, establishing such conditions is the task of economic policy. Policy is what matters overall. The key to growth of trade through improved competitiveness is granting producers and consumers the economic freedom to face market challenges and to respond to incentives.

Perceptions of what constitutes quality have evolved as well. Total quality management programs—promoted by the International Standards Organization under the ISO 9000 norms, which relate to quality restrictions—that took root in the manufacturing environment have grown in influence and are now being applied to every business func-
created opportunities for lowering cycle costs. However, by the late 1980s the usefulness of the traditional structure significantly declined for two reasons. First, a pattern of diminishing returns set in as freight rates and systems redesign reached near optimum levels after nearly a decade of assault. Second, the demands and opportunities for logistics shifted from costs to market—to the strategy for supplying it and to information about how well the supply strategy was being implemented. Increasingly, logistics became attached to other front-line functions, such as corporate strategy, marketing, information, control and procurement, as well as to manufacturing. The survey discovered that logistics is inseparable from these functions, and that formal interface with each creates new opportunities for profitability. The interface with marketing focuses on executing those aspects of the logistics process that the customer perceives as most critical to buying a product. Successful companies have recognized that time is a strategic variable that affects competitive success in the marketplace. Increasingly they are looking at logistics for ways to offset market erosion.

### The Macroeconomic Effects of a Deregulated Logistics Service Industry

Creating a policy and regulatory environment that enables national producers and traders to adjust effectively to changing practices in the international marketplace is not only beneficial to corporate performance, but also leads to improved fundamentals for the economy as a whole. Of the few countries that maintain sufficiently disaggregated national statistics to allow conclusive assessments, the United States’ performance indicators for the national economy provide evidence of the effects of service industry deregulation on logistics expenditures incurred in manufacturing and trading. Particularly noteworthy is the decreasing trend over the years in nationally aggregated freight payments (see Figure 7). After successive deregulation of the different transport modes, from the late 1970s onward, the annual logistics expenditures in the national economy dropped from an equivalent of 17.2 percent of GDP in 1980 to 10.8 percent in 1994. The average annual cost savings were in excess of US$60 billion. A further acceleration in the decline of the annual logistics expenditures/GDP ratio started at the end of the 1980s and can be largely ascribed to the effects of deregulating the telecommunications industry. Competition created better telecom-
munication service offerings, which enabled manufacturers and traders to reduce order cycles further (see Figure 8) and to turn over inventories more frequently (see Figure 9), thanks to improved linkages with transport, warehousing and other trade-supporting service providers. Higher frequencies of inventory turnover induced major increases in the annual returns on assets in almost all industries.

The policy interventions and subsequent developments in North America and, similarly, in several other OECD countries demonstrated the growing importance of transport. As the practice of manufacturing and trading with minimal inventories has spread, the demand for efficient transport services has increased measurably. For instance, while the aggregate annual costs of inventory-carrying in the U.S. economy has remained almost stable since 1980, the concomitant annual incidence of freight transport more than doubled. A typical phenomenon of modern manufacturing and trading practices is that shipment sizes tend to become smaller, whereas shipment frequencies increase significantly. Hence the intensity of transport as an integral part of industrial and marketing processes is becoming more pronounced. More than ever before, efficient transport networks have become prime prerequisites for establishing market-responsive trading arrangements. This observation applies to both international and domestic trades. In the case of international trade the availability of efficient transport services and their supporting infrastructure is now a key determinant of competitiveness. On the domestic scene the quality of local distribution networks exerts much influence on product availability and retail prices, with obvious effects on affordability and the national industries’ ability to engage in modern logistics-management practices.

Issues in Managing Latin America’s Trade

Trend projections suggest that in most industrialized countries there will be further growth in outsourcing of production processes to foreign markets. The search for less costly supply sources will continue unabatedly. There will be many opportunities for the countries in the Latin
American region to capitalize on these trends—and thereby accelerate the growth of national trade. But here as elsewhere the availability of low-cost labor no longer suffices to attract foreign investments into local productive sectors. This observation becomes even more compelling when one considers the declining share of labor costs in product-end prices due to increasing automation of manufacturing processes. While direct labor costs in manufacturing are now less than 10 percent of the value-added chain in many industries, the costs of required materials frequently represent more than 60 percent. These circumstances make it essential that the entire logistics flow is managed efficiently to cut costs, control inventories, improve fill rates, speed up receivables and reduce tied-up working capital.

There is a need in almost all countries in LAC to reassess the role played by services in contributing to growth and sustainable development, including an examination of the contribution of the logistics-service sector in facilitating the competitiveness of goods-producing sectors, and to the local economies as a whole. Policy measures have to be identified that will be instrumental in bringing about effective development and strengthening of competitive service sectors, including infrastructure related to services. The contribution that logistics services make to competitiveness in the goods-producing sectors and to the overall economy in each country in the Latin America region may well be affected by the speed at which these countries will be brought into a much more competitive international setting.

Of highest priority in this context is the need to embrace the concept of advanced infrastructure. For all Latin American countries the ability to compete in global markets now rests on the successful development not only of basic infrastructure, but more importantly on the establishment of effective mechanisms that facilitate the creation of integrated advanced infrastructure. The problem in many regional economies is that the regulation, planning and management of the different elements of trade-supporting infrastructure are disjointed and without effective coordination. There is thus a need to develop policies and administrative arrangements that bridge institutional
as well as organizational disparities and inconsistencies. Beyond creating a level playing field for advanced infrastructure service providers, governments must also provide a policy environment that actively supports the application of advanced infrastructure concepts and arrangements.

Preliminary evidence in many regional countries suggests that the development of advanced infrastructure has been hampered by incompatibility of existing systems and available technologies. The lack of strong industry associations that would take an active role in promoting such concepts is another issue of consequence. Furthermore, there is a substantial shortage of qualified human resources that are critical for the operation and management of efficient trade-supporting infrastructure and service systems. According to successful manufacturers and traders surveyed by the World Bank in Asia (Mody and Reinfield 1995) a very important consideration for adopting market-responsive advanced infrastructure arrangements is the availability of well-trained labor supply.

A key issue in almost all Latin American countries is that, traditionally, businesses have focused primarily on their internal activities and processes, honing their own systems and procedures, without much consideration of their impact on customers and suppliers. Usually, autonomous business units have developed within companies, organizing around business functions and internal cost-profit centers. Often, supply and demand forces are ignored, diminishing the potential of logistics services for greater productivity, greater competitiveness and more value added, both within the firm and at the national level. Slowness in externalization has meant isolating these functions from market signals. In contrast, the logistics service sector in industrialized countries has evolved spontaneously, conducted by firms themselves, based on competition-induced demand and technology-driven supply. Increased competition facilitated through trade liberalization, combined with technological advance, created demand for both efficient provision of infrastructure and
In Figure 9, we see trends in marketing management, focusing on the frequency of annual inventory turnover and order cycle time. The data represents a sample of 625 North American and 225 European businesses.

Modern logistics-management concepts, widespread within regional governments and the local business communities. But logistics services will only be in demand to the extent that the activities using such services operate in a setting that is vigorous and competitive enough to require them. Preliminary indications point to the existence of a dual development of logistics services in Latin American countries. In a number of these countries, several modern economic activities that rely on technological change and that normally compete in the international markets coexist with other activities that are technologically backward and traditional in their managerial and hierarchical structures. The latter have usually benefited from protection and have not undergone the productive transformations necessary for competitive success in international markets.

Thus, many regional enterprises, which could be potential users of logistics services, resist change and maintain a high degree of internalization of services. There are various reasons for this, including the low level of competition at which they operate, the fact that these firms attach higher importance to needs assessments by their own employees than that by customers, entrepreneurial failure to perceive the economic advantages of externalizing, the low level of assimilation of new technologies, concerns over confidentiality, lack of confidence in the reliability of outside suppliers, high costs and/or inadequate quality of available logistics services and, finally, the absence of policies encouraging the entrepreneur to externalize services.

The fragility of the domestic supply of logistics services in Latin American countries and the widespread inability to express a demand for such services restrict the chances for adapting domestic economic activity to the requirements of efficiency and competitiveness in a vigorous and increasingly globalized economy. Local enterprises should be enabled to develop tailor-made competitive strategies. These strategies will have to be based on such factors as the competitive structure of the industry in which they operate, their position in that industry and clear identification of their particular sources of competitive advantages. In doing so they need to explore the possibilities of creating advantages by seizing the opportunities created by new technologies, the new and changing requirements of their customers, the emergence of new segments or niches in the industry and changes in the costs or availability of inputs. These strategies have to be oriented toward gaining a posi-
tion in good time to take advantage of structural changes, to be followed by a clear perception and pursuit of innova-
tion in order to sustain advantages over time. In some LAC
countries steps have been taken along these lines, but are still at the preliminary stage (see Box 7).

There are also instances where structural adjustment programs have been launched in order to create a setting
that is more conducive to creating greater competitiveness and efficiency in their enterprises. However many of these
adjustment programs do not pay sufficient attention to the
link between logistics services and planned or actual
restructuring in the manufacturing and agricultural sec-
tors, whereas the role of logistics services is precisely that
of assisting enterprises to attain the necessary flexibility to
adjust to more competitive and uncertain situations.
Strategies for strengthening the development and compet-
itive ness of indigenous logistics services would thus have

to include specific measures focused on stimulating both
the demand for and supply of such services. Because this
demand is derived from the requirements of other sectors,
the situation faced by those other sectors with regard to
regulation and competitiveness will determine the vigor of
demand for logistics services, particularly from those seg-
ments of the regional economies that are exposed to inter-
national competition.

The development of efficient logistics services may be
assisted by better utilization of market mechanisms with
respect to the allocation of resources, price determination
and the appropriate use of supply and demand forces in the
clearing of markets. Frequently, the still limited use of
market mechanisms in several Latin American countries is
reflected in the concentration of demand in a small number
of large-scale, generally monopsonic users. But a defective
market structure is not necessarily connected with state

In several countries national trade facilitation bodies have
been established. In most cases their organization is mod-
eled after the British Simplification of International
Trade Procedures Board (SITPRO). SITPRO is a joint
initiative by government and the local business commu-
nity. Its mandate is to disseminate modern trade logistics-
management concepts, to foster interaction between
related public institutions and the national industry, to
identify issues and prepare proposals for remedial action
and to organize training on a wide scale that is open to
all sectors of the national economy. These activities have
had measurable effects on the ability of British industry
and traders to produce and market their products
competitively.

The problem in LAC countries has been that the local
service industries with relevance for trade management
were and often remain poorly organized. Little, if any,
coordination with trade and industry exists, and even
within the service sector there is only limited profes-
sional coherence. For a long time the regional govern-
ments have neglected this segment of the national
economies. As a consequence legal frameworks that gov-
ern the service sector are inadequate, the trade-related
service industry is underdeveloped and current trade
logistics-management practices are not well attuned to
the need of modern markets. It is now vitally important
to overcome these deficiencies in the regional economies
in order to enhance the international competitiveness of
local industries and national trade organizations.

To date, specific initiatives have been launched in four
LAC countries—Argentina, Brazil, Chile and Colom-
bia—with assistance from the Pan American EDIFACT
Board. EDIFACT stands for Electronic Data Interchange
for Administration, Commerce and Transport—a system
that has been brought about by the U.N. Economic
Commission for Europe. Most advanced is the system
developed in Brazil under the name SIMPRO-BRASIL.
This body has been organized by local entrepreneurs and
is the only private participant in a federal government
program oriented to produce positions and actions
for Administration, Commerce and Transport—a system
toward a Brazilian information infrastructure in line with
ongoing international developments. The membership in
SIMPRO-BRASIL is growing, including businesses
related to production, trading and the provision of ser-
ices. The organization is providing a broad array of ser-
ices to its members through electronic communication,
professional advice and training. (See SIMPRO-BRASIL's
ownership of particular services or with the monopolistic nature of demand for them. Many services rendered by the private sector exhibit clear examples of market concentration on the supply side, which does not always contribute to a better and more efficient integration of services into production or trading processes. Better utilization of market mechanisms can be achieved through changes in the regulatory framework that affects market entry and the behavior of firms.

**Strategic Options to Enhance Latin America's Trade through Better Infrastructure and Services**

Latin America's governments have at their disposal a set of instruments with which to stimulate the development of competitive service sectors. Some of these, such as trade and fiscal and monetary policies, fall within the scope of macroeconomic policy. Others may necessitate changes in the institutional and regulatory framework, and the achievement of more specific objectives may call for particular strategies aimed at positioning national enterprises in the international market. Overall, attempts to strengthen the organization and provision of services will entail devising and applying specific strategies to overcome the weaknesses characteristic of existing trade-supporting infrastructure and logistics services in the LAC region. The incorporation of foreign service providers to assist in the attainment of sustainable development, whether by facilitating access to new technologies, information networks and distribution channels, or improving capacity for training and the generation of domestic know-how, may be an important component of industrial and trade-development policy. As can be observed elsewhere, policies with regard to trade in goods have had a marked effect on the evolution and development of services. Imports of equipment and inputs for various service activities, especially high-technology products and those that support telecommunications infrastructure, need a sufficiently liberal regime not to thwart the development of the services that depend on such inputs.

Experience is still limited but shows that in order to stimulate the supply of domestic logistics services some regional governments have experimented with different instruments, including direct financial support. For instance, in Colombia the government established the Vallejo Plan, which provides for the development of service enterprises through soft financing for the purchase of equipment, international promotion and the acquisition of appropriate technologies. Other observed tactical applications include fiscal and credit incentives, and modification of the regulatory systems to reduce or remove the boundaries between different services. There also have been attempts to promote the supply of logistics services on the basis of incentives for the externalization of locked-in knowledge, the establishment of service centers, and training facilities aimed at teaching the essentials of logistics services and their role in modern-day competitive practice. But success with these measures has been limited.

The outlook is not promising without substantial improvement of regional infrastructure, a liberal regulatory framework that governs the service sector and businesses that are willing and able to apply modern logistics-management techniques. In effect, regional countries and their business communities that are unable to adjust to these new market practices will face the risk of becoming marginalized in the international trade markets. Against the international experience record to date, it appears unequivocal that a key criterion of the required adjustment agenda relates to infrastructure and services in support of industrial and trading processes. More specifically, the establishment of effective transport and telecommunications arrangements—both from an infrastructure and service-organization point of view—should be given prime consideration.

Distance is critical in logistics management and equates to transport dependency. Since many Latin American countries are remote from the principal consumer markets, they are crucially dependent on efficient arrangements for freight transport. It is also important for policymakers to appreciate that demand-responsive production with lower average inventories translates into an increased requirement for small shipments in effectively controlled logistical environments, which signifies high transport intensity. As the experience in the OECD community exemplifies, the implication is that rectifying transport system shortcomings should be high on the reform agenda of Latin American countries in their drive to increase the competitiveness of their national industries. But the OECD experience also points to a number of significant consequences that a liberalized markets entails, about which the regional policymakers should be aware (see Box 8). A special challenge will be to design regulatory provisions and organizational arrangements that will yield optimal use of existing physical network structures. The development of efficient
Attempts have been made in the OECD countries to arrange for the carriage of goods by combining different modes, based on their respective operational and cost advantages—it is called intermodal transport. The emphasis was on combining freight transport by road and rail through different technologies. But the market share of such intermodal transport arrangements is still limited—15 percent in North America and barely 5 percent in Western Europe. The economics of truck-only transport remain compelling. Some OECD governments pursue policies aimed at forcing the use of intermodal transport arrangements through regulatory intervention. Early indications are, however, that such steps seriously undermine the competitiveness of the national industries and trade.

The challenge for LAC governments will be to establish conditions under which the national transport system can meet the special logistical requirements of local industries and trade. Costly mistakes have to be avoided, and the OECD experience should be carefully considered. For a long time trucking will remain the preferred mode of freight transport.

intermodal freight transport systems should be given high priority—based on the comparative advantage of different modes—if overly heavy reliance on road transport is to be avoided. Shippers prefer road transport because of its apparent flexibility, which other modes—in particular the railways—have failed to produce. However, prolonged reliance on road transport for freight movements has led to severe economic and social problems in many OECD countries. To counteract these adverse impacts, their governments are now actively devising measures aimed at increasing the share of other modes through dedicated efforts to promote intermodality. Latin American governments should capture the opportunity to avoid the costly mistakes of the (initially) misguided regulations and investment decisions related to freight transport systems in the OECD economies.

Consequentially, the required adjustment process in the regional countries is diversified and invariably complex. As regards transport, some affirmative actions have already produced beneficial results. Throughout South America, governments have abolished protectionist policies with regard to ocean transport, leading to extensive competition between national and foreign-flag carriers. As a result, freight rates for waterborne transport have tumbled 30 to 50 percent since 1994. Equally decisive in the effects, the admission of private interests in port financing and management in many of the regional ports has led to decreases in terminal handling charges by up to 70 percent as productivity improved considerably, driven by fierce intra- and inter-port competition. While there have been consequential losses of market shares by national entities that formerly enjoyed quasi-monopoly status in shipping and ports, the outcome of opening these sectors to international competition has yielded measurably positive effects on national trade performance.

Impressive as these outcomes have been, significant inefficiencies continue to exist beyond the waterfront. The
physical condition and the performance of inland distribution networks are still far from adequate. The reasons are manifold. Most cumbersome are local regulations that stymie initiatives within the national transport sector to become more responsive to changing shipper requirements. The concern of ensuring quality, competitive prices and adequate provision of services, while at the same time adapting them to technological advances, places transport service suppliers under pressure to improve management and operational efficiency. It is encouraging that in some countries governments have come to appreciate the apparent inability of state monopolies in transport and other services to meet this challenge, giving rise to policies aimed at privatizing these monopolies. It is hoped that the demands of a more competitive environment will provide the necessary stimuli for technological progress to focus its creativity on developing new and better services, tailored more closely to the requirements of the production and distribution processes. New and enhanced services, associated with modern information technologies, will increase productivity for both goods and other services. They will also facilitate the application of new management techniques, make relations between the various stages of design, production and marketing of products and services more expeditious, allow customized services to appear, help to create greater economies of scale and facilitate an efficient globalization of the production and distribution functions.

In many Latin American economies the laws and regulations that govern the conduct of trade and the organization of trade-supporting services and infrastructure have barely been changed since the time of their promulgation, decades back. Hence, their provisions are substantially out of line with the exigencies of modern markets. Such situations are all the more critical as most elements of the service sector relevant to supporting trade—transport, freight forwarding, warehousing, telematic information systems, banking and insurance—have become increasingly interdependent to yield efficiency. Failure of one element in this
interdependent setting to respond efficiently to market
requirements usually undermines the performance of all
other elements—the weak link syndrome.

One of the most important aspects of modern logistics
management is internationally harmonized documentary
procedures which enable speedy electronic transmission of
freight bills, payment orders, insurance contracts and
transactions relevant to the movement of goods. A modern
and efficient telecommunications infrastructure capable of
supporting, at low cost, the domestic and international
development of such varied services as banking, transport
and other logistics services that are direct users of such net-
works is indispensable. In countries where major advances
in streamlining logistics-management organizations have
been achieved, customs or excise clearance of traded goods
has also been integrated into the electronic communication
systems. As a result, such clearance is usually swift. In con-
trast, complicated and hence tedious customs practices in
many Latin American countries remain one of the prin-
cipal obstacles to better trade performance. Ways have to be
found—on a priority basis—to remove this bottleneck.
Governments are rightfully concerned about ensuring
proper revenue collection and fighting contraband. But
there are successful ways of safeguarding against such con-
cerns while facilitating trade transactions at the same time.
The reforms in customs regulations, organization and pro-
cedures in Mexico provide a good example for possible
replication elsewhere, if adjusted to local conditions (see
Box 9).

Adjusting national infrastructure to the special require-
ments of trade and the supporting services is demanding
and considered to be costly. But all LAC countries are
endowed with infrastructures that have been developed
over generations. Often, the problem has been not so much
a lack of resources, but an inability to use existing resources
well. To some extent such a state of affairs is, again, due to
overbearing regulations and too much state intervention.
On the other hand, in areas where the state could rightfully
be expected to take a more proactive role, it has largely
failed to do so. The dismal state of highways and rural
roads throughout Latin America attests to this observation,
which has been widely acknowledged by many regional
politicians, public administrators and business managers.
Without well-maintained roads it will be difficult to orga-
nize efficient trade and industry logistics-management sys-
tems regardless of how good the quality and low the costs
of local products are when they leave the assembly lines or
the farmers’ fields.

Trade-supporting infrastructure needs, above all, to be
well maintained. Without doubt, such infrastructure will
also have to be modernized as well, so that the productiv-
ity potentials of new transport and freight-handling tech-
nologies can be fully exploited. Budget constraints in
many Latin American countries will limit the scope of such
required interventions. Hence, ways have to be explored to
tap nontraditional sources of finance, which largely points
to attracting private capital. The experience in a number of
Latin American ports suggests that attracting private cap-
it goes hand-in-hand with involving private expertise in
asset management. As successfully demonstrated in many
countries throughout the world, there is ample scope for
creating synergies through public-private partnerships in
financing and managing trade-supporting infrastructure
and services. But to succeed there has to be unequivocal
commitment within governments to such partnerships,
accompanied by transparent legal frameworks that will
govern such alliances.

Other than ports, there are now also developments in
several Latin American countries to involve private capital
and management expertise in making national railways
more responsive to evolving market requirements. In addi-
tion, some regional governments have decided to engage
private contractors in highway maintenance and to build
new trunk roads as toll facilities through concession
arrangements. Yet more needs to be done to make local
industries more competitive internationally and to reduce
the costs of domestic trading. Importantly, more effective
dialogue between the public administrations and the busi-
ness communities is needed. Business requires freedom of
action while maintaining the concept of “checks and bal-
ances.” Experience has repeatedly shown that, once given
the freedom to take measures considered to be profitable,
private entrepreneurs have invested in market-responsive
infrastructure and service arrangements that turned out to
be beneficial for national trade performance. An outstand-
ing regional example is represented by the initiatives taken
in Argentina with respect to involving private interests in
the management of national railways, ports, airports and
parts of the local highway system. Clearly, the state needs to
ensure that abuse of newly acquired rights is avoided, but
the dynamics of private management of national trade sup-
porting infrastructure and services cannot be overstated.
In the early 1980s, Mexico’s economy experienced a sharp downturn, which brought in its wake severe balance-of-payments difficulties. The government responded with a number of reform initiatives that, over the years, had the result of transforming the country into an open economy. The industrial base changed and so did the nature and composition of foreign trade. Non-oil merchandise exports, which represented less than one-third of total exports in 1984, have doubled their share since then. But there remained a number of impediments to efficient trade flows. A key one was customs administration and procedures, which were not adjusted in line with the trade reforms.

Customs procedures were highly centralized and antiquated, involving numerous, complex, time-consuming and non-transparent steps. Traders faced long processing delays and substantial undocumented costs in clearing merchandise. An enormous amount of legislation and ordinances applicable to customs had proliferated over the years, many were never published and underwent constant changes. No uniform standards for application of the rules were exercised. Almost unlimited discretion and negotiating power were given to customs officers, with the result that the authorities had lost control of the process. The Directorate General of Customs (DGC), part of the Ministry of Finance, operated with nearly full independence and little supervision. This situation was aggravated by tight limitations of customs broker licenses. The brokers enjoying such licenses were generally considered to be major accomplices in customs irregularities. The structure of broker fees was such that 70 percent represented compensation for “undocumented expenses.” Thus, there was a clear incentive to increase such discretionary payments to customs officers.

In 1989, the government stepped in and introduced major changes in the organization and management of customs services. DGC was stripped of many of its prerogatives, which were assigned to other agencies within the Ministry of Finance, and was left with the sole mandate of facilitating the physical process of customs clearance and prevention of smuggling. The customs administration was decentralized. Top-line staff were reshuffled and some replaced to collapse colluding cliques and to encourage more professionalism. Customs reform is part of an overhaul of the tax system, and customs has now been integrated with general tax collection. The rights and obligations of traders and customs have been widely published to enhance transparency. Traders no longer make payments of tariffs to customs officials but to commercial banks, which opened branch offices in customs facilities.

Widespread computerization and electronic data linkages are the backbone of the reformed inspection system. A computer-generated random selection process now determines which trade transactions are to be inspected. The intention is to remove discretion and negotiability. The number of steps in the customs process has been reduced from 12 to four. The new system has led to the closure of several inspection facilities. If customs clearance is not obtained at the frontier, it must now be done at an interior site within the jurisdiction of a trader’s local tax office. This measure removed the past need for lengthy detours to clear customs at interior sites with no obvious geographical relationship to the trader. Entry to the previously tightly controlled brokers’ segment has been liberalized, and the regulated fee structure was phased out. Brokers have to compete, which will determine the level of their fees. Any irregularities are subject to stiff fines. The remaining customs personnel benefit from an official incentive scheme whereby they receive bonuses for meeting predetermined productivity levels.

There is much evidence that the immediate effects of these reform measures have been substantial. A World Bank survey assessed first-year cost-savings at US$2.05 billion, which represented about 5 percent of the total value of merchandise trade in 1989, or close to 1 percent of GDP. These savings resulted from an average three-day reduction in customs transit time, with attendant reductions in the costs of interest, storage and transport, as well as lower broker fees, and it eliminated “undocumented expenses.” It is also noteworthy that the daily collections of customs duties at different facilities increased 12 to 15 percent.
The governments' role should gradually shift to being a promoter rather than manager of trade-supporting infrastructure and services. The regional governments should be facilitators and create an enabling environment in which local industries and the trading community can adopt modern logistics-management concepts with all their proven enhancement potential as regards productivity and competitiveness. Very importantly, governments must actively endorse and, where necessary, supply advanced infrastructure. For the forward-looking government, establishing a regulatory framework that supports advanced infrastructure development is a must. In this general context, government policy should not restrict entry or operations of qualified international service providers.

There are other important situations where government involvement in the development of services and applications may be not only appropriate, but essential. Government assistance is particularly crucial if the local industry primarily comprises small companies or if they do not have strong industrial associations. In the case of Taiwan, China, the automotive industry lacked the kind of competitiveness that would drive manufacturers to develop electronic data interchange (EDI) systems in support of trade management on their own. But by having automobile suppliers linked to such a system, manufacturers could be expected to benefit, and the industry itself become more appealing to foreign markets for higher value-added products. Since the local value-added service providers did not have strong incentives in this fragmented market to develop EDI, it was appropriate and useful for the government to develop such service.

The technology used for applications associated with advanced infrastructure often requires large research and development expenditures that the private sector, by itself, might not be willing to absorb. In such cases it may be appropriate for the regional governments to become involved through general funding support and initial development at one of its own institutes or local polytechnics. Governments may also be appropriately involved in service or application development in situations where there are so many participants that it requires the leadership and authority of public agencies to garner the cooperation needed to develop a system.

A task for which Latin American governments should arguably take a leading role is human resource development. What use is modern technology if a country's workers cannot read the instructions on a bag of fertilizer, let alone if they or their managers are ignorant of the essential ingredients of modern trade and industry logistics-management organizations? Successful initiatives to overcome such issues can be observed in some of the Central and East European transitional economies, which were confronted with the same problems (see Box 10). The process of change has been assisted by increasing levels of technical education, which has facilitated the international transferability of technology. One of the most striking features of the fastest growing among the newly industrialized economies of East Asia is the very high commitment to basic education. But one also needs to ask under what sort of conditions will the right sort of action happen? The simplest answer is, under conditions that grant the investor—a firm buying a new machine or sending an employee to be trained—an adequate return. In many regional countries such conditions are still imperfect, which is why the adjustment process has been slow and ineffectual.

The bottom line is that the challenge facing policymakers in the countries of Latin America is to establish conditions that would enable the local economies to attract more global production, and to realize more of its benefits through enhanced trade transactions. Such conditions include enhanced political and macroeconomic stability, improvements in transport and communications infrastructure and better property rights for investors. A crucial condition for capturing more benefits is more competition. In general, policy is most effective when it is harnessed to a realistic appreciation of where a country's competitive strengths lie. Policies that encourage greater competitive pressures on all firms from all sources are likely to maximize the benefits that the regional countries could derive from global production, because competition forces firms to be more efficient. More open trade and investment frameworks are among the best channels for introducing such competitive pressures in traded-goods sectors. In the service sectors, they need to be complemented by the encouragement of foreign investment and well-designed regulatory policies that enhance competition. In all this, there should be concerted efforts, involving the public administrations and local business communities, to promote and develop advanced infrastructure in support of national production and trading.

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Public-Private Partnership in Human Resource Development for Managing Trade and Industry Logistics

World Bank sector work revealed that the concept of integrated logistics management was widely unknown in industrial and trading circles in Hungary. Application of modern logistics-management principles in manufacturing and marketing processes was therefore limited. Most critical was that Hungarian manufacturers and traders were largely unaware of the growing importance of effective logistics organizations in competitive practice elsewhere in Europe. It had become a matter of vital importance for Hungarian businesses to adopt the same logistics practices that have enabled their foreign competitors to gain and expand their market shares.

As an integral part of the World Bank-supported Product Market Development Project, a national Logistics Promotion Center (LPC) has been established as the principal agency for institution building and human resource development. LPC's mandate is:

a) to further awareness within the national industry and trading communities— and the service sector—of the importance of effective logistics organizations for commercial success, and to organize corresponding public-relations campaigns;

b) to be the focal point and facilitator of discussions regarding the organization and management of logistics related training and formal education in Hungary;

c) to act as adviser to anybody who is in need of assistance to introduce or streamline trade and industry logistics organizations, or to arrange for logistics-related personnel training; and

d) to establish and maintain professional contacts and expert exchange programs with similar organizations in other countries.

LPC was established as an independent organization of public utility under the umbrella of the Hungarian Foundation for Industry (IMEA). IMEA's mandate is to "support the technical development of Hungarian industry to increase its international competitiveness." Several private-sector organizations committed their full support and are actively involved in LPC's activities. They include the Hungarian Association of Logistics, Purchasing and Inventory Management, the Hungarian Marketing Association, the National Trade Association and several bodies representing different segments of the local industry.


I MUST CONFESSION SOME CONFUSION ON HOW TO ADDRESS THIS COMMENT. I COULD NOT FIGURE out what is the main question that the authors are attempting to answer. Is it: What is the role of infrastructure availability in promoting foreign trade in Latin America? Is it on promoting total trade or only regional trade and, thus, on commercial integration?

Or the question could be more specific or quantitative: To what extent is the lack of adequate infrastructure stopping the growth of trade or exports? If this had been the concern of the authors, one could have moved into analyzing what type of infrastructure is missing most in Latin America. Is it roads, ports, telecommunications, services of a particular nature?

If the main interest were in policy decisions, the key questions might have been: In which type of infrastructure is the rate of exports growth higher per dollar invested? Is it higher per dollar invested in railways or highways?

All these are very interesting and relevant questions. At least in Chile there is a very strong political and economic debate on what the government should do to maintain the rate of growth of exports in view of a declining exchange rate. Today an exporter gets 420 pesos per dollar, when seven years ago the exporter got 650 pesos with the 1997 purchasing power. To face this situation some economists, businessmen and politicians say that the government should reduce import-tariff rates, others say it should sign more free-trade agreements, others say it should increase the exchange rate by reducing public expenditures, and still others say it should mainly improve the country’s infrastructure through the privatization of ports, highways and railroads.

Unfortunately, the paper we are commenting on did not address these questions, nor did it present many specific examples of successes or failures of individual countries or sectors within countries. It would be interesting for Latin American policymakers to have empirical evidence about the correlation between trade development and the improvement of infrastructure. This could be done either through case studies or cross-section analysis.

Common wisdom would say that there is a very high positive correlation between investment in infrastructure and trade growth. But life is not that simple. Few people have addressed this question without prejudices. Engineers writing about infrastructure development take it for granted that there would be no trade development without adequate infrastructure. But I browsed through several papers and books about trade (like Meller’s “El auge exportador Chileno”), which attempt to explain the success of Chile in expanding its exports, and found almost no mention of the availability of infrastructure as a key explanatory variable.

With this I do not mean to imply that infrastructure is not relevant at all. What I mean is to call for more analysis of the matter, which would draw more fine distinctions about export sectors, kinds of infrastructure, countries and

Ernesto Tironi is Director of GasAndes in Chile.
other conditions, like timing. A key question, in my view, is whether the building of the appropriate infrastructure should precede the development of exports. In other words, is it a precondition in order to expand certain exports? If this is the case, should the public sector always run the risk of making these investments? What assurance can there be that exports will follow, thus justifying the initial investment in infrastructure? The world seems to be full of examples of "white elephants" (oversized ports, for example) built by countries on the expectation of exports or other activities that never developed.

What I find most interesting and encouraging in Latin America in relation to its infrastructure is how it is being positively affected by regional integration and by competition.

Traditionally the economic literature in the region (especially the more "structuralistic" literature) has stated that we need more investment in infrastructure in order to foster integration among our countries. This is the base for the calls for the construction of "bi-oceanic corridors," cross-ocean railroads, etc. Paradoxically, we are now finding a different inverse process: that integration is fostering investment in infrastructure. I postulate, in addition, that the latter will contribute strongly to expand Latin American trade, both globally and regionally.

Look at what is happening in the natural gas and electric generation sectors. I will refer mainly to the Chile-Argentina case, because I know it better, but the same is happening with Argentina and Uruguay, Argentina and Brazil, Bolivia and Brazil and is starting (or will start very soon) with Venezuela and Brazil.

The return to democracy in Argentina and Chile inaugurated a new era of cooperation between the two countries that, among other things, led to the signing, in 1991, of a "Gas Protocol" that permitted the export of natural gas from Argentina to Chile. Initially it was quite restrictive. Later, with the privatization of YPF and further deregulation in Argentina, the protocol was amended in June 1993, and a true opening of the gas border took place.

Elementary economics teaches us that international trade occurs as a result of price or cost differentials arising from differences in natural resources availability. This was the case of natural gas between Argentina and Chile. The latter has no gas, except in Magallanes, 2,000 kilometers south of its main consumption centers. On the other hand, Argentina has the second-largest gas reserves in the region and a well-developed gas-pipeline network. Gas is used mainly to generate electricity, so prices of electricity were more than 20 percent higher in Chile than in Argentina.

The elimination of the gas trade prohibition attracted, therefore, a number of investors trying to get into the business of shipping gas between the two countries. But following Argentine traditions, all investors sought an association with the state or the state-owned company (YPF), and they wanted government financing or guarantees to invest. It came as no surprise that almost five years had passed and the construction still had not started, notwithstanding dozens of press statements about the progress of the project, state visits and ceremonies. Only when the countries agreed to open up the market and established an open access system (no exclusive state concessions) did fierce competition start, which resulted in the first pipeline being built in less than two years.

Five conditions have been crucial for the development of an integrated gas and electric infrastructure for Chile:

1. Similar and open regulatory frameworks in Argentina and Chile;
2. Companies in the sector that are either private or in the process of being transferred to the private sector;
3. A competitive free market;
4. Resources that are not defined as "strategic" and thus subject to special state regulation; and
5. Openness toward foreign investment.

The result has been a substantial reduction of the price of electricity in Chile. The prices have already fallen more than 10 percent, even before the gas starts flowing this month. In addition, it has generated a $1.1 billion investment, considering only the pipeline construction in Chile and Argentina, three power plants in Chile and the gas distribution system in Santiago. It will also mean about $80 million in annual exports from Argentina, more activity for its gas sector, and demand for the Argentine construction company that built the pipeline, for the steel mill that produced the pipe, and for many other engineering and service companies. More than 1,000 people have worked in the pipeline construction for one-and-a-half years on both sides of the border. Last but not least, Santiago now has a hope of eliminating the cloud of gray smoke that is suffocating the city.

Because of this success, construction of two additional gas pipelines from Argentina to Chile has started. One is in the south, to Concepcion, called Gas Sur, which will involve at least $500 million in the next three years. The
other is likely to be built in the north for the copper mines in the Antofagasta Region, and would imply a 900-kilometer pipeline, with an investment of at least $650 million.

This will, in fact, integrate not only the energy sectors of Chile and Argentina, but the north and central-south electric grids of Chile, which were not interconnected until now. It will reduce electricity prices in the north by about 30 percent. In addition, the quality of service will be improved both in the north and the south because there will be a more balanced supply of electricity coming from hydroelectric and thermoelectric sources. Prices will also be much more stable.

I see no reason why similar experiences cannot be replicated in other infrastructure sectors. There is news that a private railway company operating in freight transport in Chile is thinking about joint operations with a private Argentine railway company. This will probably mean building new tracks. With the private concessions of highway construction and operation both in Argentina and Chile, I see no reason why there could not be a joint project soon to improve road transportation between the two countries. And the day that ports are privatized should bring an important competition in that sector, which is vital for export expansion.

In the case of the electricity sector, the next regional integration projects are transmission lines: First the ElectroAndes Project with a 400-kilometer line between Salta in Argentina and the Chilean northern grid close to the Zaldivar copper mine. This involves constructing a combined-cycle gas power plant in Salta for a total investment of around $300 million. Then there will be a new line between Argentina and the south of Brazil. It is also very likely that there will be an electric interconnection between the Comahue area in Neuquén, Argentina, and the Lakes Region in the south of Chile within the next five years.

As for the rest of Latin America, the integration of the energy infrastructure is only beginning. Aside from the GasAndes and Gas Sur pipelines, there are at least seven on the drawing boards. This is especially true in Brazil, but all the region will be requiring large amounts of electricity for its development. Expected investment for the next 10 years is more than $60 billion. Electricity will not come mainly from hydroelectric sources, as in the past, for two main reasons—first, because of environmental restrictions on building large dams, and second, because of technological breakthroughs that have increased the efficiency and reduced the price of gas-fired power plants.

More than half the consumption of electricity in Latin America comes from Brazil, but it has less than 3 percent of the gas reserves. Argentina and Venezuela, on the other hand, have 12 and 70 percent of the proven natural gas reserves of the region. Thus, it is no wonder that pipelines will start to be constructed soon both northbound and southbound.

Bear in mind that cheap and reliable electric power is a necessary condition for economic development, and especially to expand exports in world and regional markets. Take the case of mining. People believe that producing copper is only a matter of being lucky enough to have the deposits. They seldom realize that around 30 percent of the cost of mining copper comes from electricity. Thus, its availability and price is critical. The energy integration of Chile and Argentina, with its lower electricity prices, means a nearly 10 percent cost reduction in mining.

We shall soon hear more about Argentina's becoming an important copper-mining country. This is also possible as a result of the integration between Argentina and Chile, as well as from the deregulation that is allowing the two countries to build and use the required infrastructure jointly. One of the new mines will be Pachon, about 400 kilometers north of Santiago. It will most likely be supplied with electricity generated in Santiago from gas that has come from Argentina. If not, it will be supplied from San Juan, from a new gas power plant constructed by a Chilean company there. Anyway, copper is most likely to be shipped from the Chilean port of Los Vilos. Similarly integrated projects will come soon.

Latin America still has a long way to go in developing its infrastructure. Take again the example of electricity. Chile is the country that has more electricity available per capita, at 2,000 kilowatt-hours per person. Brazil and Argentina have about 1,600. Peru has 500. These are a tiny fraction of the consumption in the United States (more than 12,000), Japan (8,000) and Germany (7,000). This gives us some idea of the needs in infrastructure if we expect to become developed countries within our generation.

Therefore, the concern of the World Bank about the role of infrastructure development on Latin America's economy and trade is most relevant and timely. And if the Chile-Argentina experience with the development of their energy
infrastructure is considered successful, the key conditions for it are now known: similar open regulations, strong private companies, free markets, no special “strategic” regulations and openness toward foreign investment.
IX. Integration of Financial Services
The Integration of Financial Services in Latin America

ROBERT ZAHLER
CARLOS BUDNEVICH

RECENT YEARS HAVE WITNESSED A PROFOUN D PROCESS OF GLOBALIZATION OF ECONOMIES all over the world, reflecting both the spectacular progress that has been made in communications and technology and the deliberate strategies of economic openness that most countries have adopted. These factors have promoted the internationalization of the world economy. At the same time, three great economic blocs, centering on the United States, Europe and Japan, have been emerging, and they pose several major challenges to Latin America.

In the first place, in terms of strategy and negotiations, the region will need to define and adopt a position with respect to the new realities of international coordination and cooperation. Second, unless there is a deliberate attempt at coordination among the three great blocs, the economic cycles in the various parts of the industrialized world are very likely to fall even further “out of synch” with one another than they are already. This could have implications for the entire international system and could induce the three blocks to turn inward—after all, they already see themselves increasingly as equals in terms of power and economic influence, and as less dependent on developments in the international economy than they once were. Third, we need to ask ourselves whether it is time to return to a more “integrationist” approach to development within Latin America.

In fact, as globalization has advanced, Latin America has, with varying degrees of commitment and intensity, been making efforts, inspired largely by Europe’s example, to promote regional and subregional economic integration. It goes without saying that these efforts to date have not enjoyed the same degree of success as those undertaken in Europe since the Second World War. What Europe did, in effect, was to launch itself into an experiment of trade and financial integration that, while not without its problems, is now about to reach a level of development that is more advanced, more sophisticated, deeper and broader than ever before—a level of integration that has profound implications for political and economic systems at the national, regional and international level.

It is important to note, nevertheless, that Europe’s financial integration has begun to materialize only after 40 years of successful commercial integration, which has seen a long process of liberalization, sound regulacion and coordination, and several years of uninterrupted functioning of a single market. Our region, in contrast, is far from matching Europe’s integration achievements in terms of their pace, depth and freedom of movement. In particular, the integration agreements that have been implemented in Latin America have never produced any schemes for financial or monetary integration. We have agreements in the field of international payments mechanisms and reciprocal credits, but they fall far short of anything resembling financial integration, much less monetary integration. Moreover, it is

Robert Zahler is President of Siemens-Chile and of Zahler & Co., Santiago, Chile. Carlos Budnevich is Manager of Financial Analysis, Studies Division, Banco Central de Chile, Santiago, Chile.
clear that much remains to be done in Latin America in terms of integrating trade, the environment, transportation and communications infrastructure, labor mobility and tax complementarity, areas in which progress has usually proceeded ahead of or in step with financial integration.

In light of the foregoing, the purpose of this paper is to attempt a first approach to the topic of integrating financial services in Latin America. The analysis starts from a perspective of autonomy in monetary, regulatory and banking supervision policy. It deals with the concept of financial integration and with the preconditions for such integration, and it proposes the kind of financial integration to which the region might best aspire, setting out the macroeconomic conditions and the principles of financial and banking regulation that the different countries of the region would need to have in common if financial integration were to proceed. And it concludes that financial integration in Latin America has been and remains on a slower track than commercial integration, and that what progress it has made is due more to de facto adaptations to reality than to any top-down programming approach. It also concludes that for the foreseeable future it will not be possible, nor even necessarily desirable, to achieve full coordination in macroeconomic policies, nor is it realistic to hope for complete harmonization in financial regulation. Nevertheless, the paper suggests some principles and measures that might contribute to a process of financial integration—one that would initially be limited, but effective, solid and durable, and that might serve as a starting point for more ambitious goals down the road.

**Preconditions for Financial and Banking Integration**

By financial integration, we mean the movement of capital among member countries of an integration scheme, performed via financial institutions, without any barriers to impede the free transfer of resources across frontiers. In general terms, it includes all the institutional players in the financial system, of which banks, finance companies, pension funds, investment funds, mutual funds, insurance companies and brokerage houses are the most important in Latin America, and the ones that have been subject to the greatest degree of financial integration. Table 1 shows that, in Latin America, a significant proportion of financial intermediation is performed by the banks. In fact, with the sole exception of Chile, where banks are responsible for 62 percent of intermediation, in all other major countries of the region at least 86 percent of financial intermediation is done by the banking system.

It should be noted, however, that pension funds are acquiring a growing importance. As the trend toward privatization, individual capitalization and internationalization of these funds continues, and as the banks feel the effects of growing disintermediation, nationally and internationally, with the rising competition from non-banking activities and from technological progress in informatics and communications, pension funds will be playing an increasingly active role in cross-border trade and investment and the flow of financial services.

Experience shows that the most successful development strategies based on external economic openness are those where trade liberalization has preceded financial deregulation. Moreover, if a country’s financial integration into the international economy is to be sustainable over time, there has to be a competitive exchange rate, together with a lowering of tariffs and the dismantling of non-tariff barriers, to encourage greater development in the export sector. Again, if financial opening occurs ahead of or at the same time as commercial opening, this may put the country’s export sector at risk, by inducing strong upward pressures on the domestic currency. This will not only act as a dampener on exports, but will call into question the sustainability of the current account deficit in the balance of payments and can even jeopardize the success of the openness strategy itself. The ideal sequence, then, is to go about liberalizing the

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<th>Bank Participation in Intermediation</th>
<th>Bank Concentration</th>
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<tr>
<td>Venezuela</td>
<td>92</td>
<td>57.2</td>
</tr>
</tbody>
</table>

c. Salomon Brothers 1996 data.

Source: BIS and Salomon Brothers.
capital account gradually and selectively, and only after trade-opening measures have been completed.3

**Macroeconomic Stability**

If the process of financial integration is to be effective and durable, the countries of Latin America first will have to achieve macroeconomic stability, or to be well on their way toward it. Capital flows can be very volatile, and exchange risks and sovereign risks very high if a country’s macroeconomic fundamentals are not sound, and those risks will for all practical purposes impede the smooth exchange of financial services.4

The process of financial integration does not demand absolute coordination among different countries’ macroeconomic policies, but it does require a strong and demonstrable commitment to maintain macroeconomic stability. For example, countries that decide to proceed with financial integration might well take it upon themselves to comply with criteria similar to those of Maastricht, whereby they agree to set bands or ranges within which the key macroeconomic variables of the different countries are allowed to move. This does not mean that their macroeconomic policy tools must be made uniform. Indeed, to the extent that they share the same final objectives and produce converging macroeconomic results, a financial integration scheme could embrace, for example, countries that follow a fixed nominal exchange rate with full convertibility (Argentina) and others with a discretionary monetary policy that is firmly anchored in explicitly stated inflation goals (Chile), and still other countries where monetary policy is formulated and implemented on the basis of monetary or credit aggregates (Peru and Mexico).

The economic landscape of Latin America during the 1990s has been marked by the introduction of structural reforms and stabilization programs aimed at reducing inflation and achieving sustained economic growth. This has induced a greater degree of convergence in the various macroeconomic indicators for countries of the region than prevailed during the 1970s and 1980s. Whereas in 1990 the average inflation rate stood at about 1,200 percent a year, by 1996 it had fallen to 19 percent, and spanned a range of 1 percent to 47 percent. Again in 1990, of the 19 Latin American countries reporting statistics to the U.N. Economic Commission for Latin America and the Caribbean (ECLAC), four were experiencing hyperinflation, only six had inflation of less than 30 percent a year, and one lonely country had single-digit inflation; by 1996, in contrast, eight countries were in the single-digit range, and only one had annual inflation higher than 30 percent. At the same time, real interest rates were between 6 percent and 15 percent, fiscal balances ranged between -6 percent and +3 percent of GDP, public debt stood between 28 percent and 106 percent of GDP, and the current account balance was between -7 percent and +1 percent, while unemployment varied from 3 percent to 17 percent.

The European Union is clearly far ahead of Latin America in terms of the convergence of such variables as inflation and real interest rates, and only slightly ahead when it comes to the current account deficit on the balance of payments. Yet the fact is that Latin America has better indicators and greater convergence than the European Union in the fiscal sphere, both in terms of deficits and public debt as a percentage of GDP, as well as in unemployment rates.

As noted above, it is very difficult in Latin America to think of total macroeconomic coordination and a common set of overall objectives, given countries’ different stages of progress toward reform and stabilization, their varying degrees of external openness, the distinct vulnerabilities of their economic structures, and the disparate sources of shocks to which they are exposed. What would seem useful and desirable would be to create and mobilize an efficient and regular mechanism for exchanging information among national economic authorities, and to reach a significant degree of consensus on the macroeconomic goals that they should be pursuing.5

A regional or subregional agency, as appropriate, might be able to monitor and publish regular information that countries, and their financial institutions and commercial banks, could use in making decisions about internationalization.6 Similarly, the integration process would be given a boost if countries could agree to cast their economic policies within certain ranges of current account deficit-to-GDP, inflation and fiscal deficit-to-GDP, and to adopt indicators of external and internal solvency and liquidity, such as net foreign-currency external debt, the ratio of public domestic debt to GDP, the ratio of international reserves to imports, and the level of international reserves in relation to the sum of external short-term debt plus domestic short-term financial liabilities in foreign currency, among others.

With respect to this last kind of indicator, the sustainability of the external balance, measured in terms of flows and reflected in the current account balance, needs to be
supplemented with a proper analysis of the situation in terms of stocks, which is reflected in the strength of external solvency and international liquidity indicators. In particular, countries should have a sound international reserve position, both with respect to the short-term maturity structure of their external debt and their domestic public debt and the foreign-currency liabilities of their banking system. This would help to induce a more stable behavior in net capital flows, and it would above all avoid sudden interruptions in capital inflows and a stampede to take money out.

Liberalization, Regulation and Financial Supervision
Together with stability and greater macroeconomic convergence, regional financial integration requires the liberalization of domestic financial systems, in the sense of eliminating quantitative controls and the selective allocation of credit, deregulating interest rates, regulating the granting of banking licenses, etc., so as to encourage greater market competition and setting reserve ratios that will reconcile the maintenance of adequate bank liquidity levels with the development of financial intermediation. It is essential to recognize at the outset, however, that such liberalization must go hand-in-hand with proper banking supervision and regulation.

It must be borne in mind that a simultaneous process of domestic and external financial liberalization can lead to heightened competition in financial markets and make it more difficult to digest inflows of capital, particularly in the banking sector. Experience shows that this situation contributes to a temporary and unsustainable rise in asset prices, especially for non-tradable assets, and it at least allows, if it does not actively encourage, the emergence of price "bubbles" in the stock market, as well as the overvaluation of domestic currencies, all of which stimulates excessive domestic spending and raises the current account deficit of the balance of payments, factors that work against exchange-rate and financial stability and overall macroeconomic equilibrium. Moreover, in these cases there is a tendency to relax both supervision and self-regulation of the banks, which can lower the quality of the banking system's loans portfolio and increase its risks, while the banks lose their effectiveness as transmission belts for monetary policy.

The foregoing will be even more true in cases where, prior to external financial opening, the domestic equilibrium interest rate is higher than the international, and there is a sudden liberalization of the capital account. On the other hand, if the internal equilibrium allows domestic interest rates to stay roughly in line with those abroad for reasonable ranges of country risk and exchange-rate expectations, financial opening can be approached more quickly and completely, without having to mortgage the stability of the external sector, jeopardize inflation goals or put the real exchange rate at risk.

On the other hand, explicit or implicit guarantees of interest rates and exchange rates exacerbate the inflow of capital and give rise to behavior that implies moral hazard and/or risk. The best way to avoid these problems is to follow a combination of monetary and exchange-rate policies that will allow for greater flexibility and a greater market role in the setting of interest rates and the exchange rate.

If financial flows handled through the banking system are to be appropriately channeled to the various sectors of the economy, and since loans are not generally secured, there is a need domestically for provisions based on individual credit risk, and internationally for country-risk provisions, to the extent that there is a risk that the foreign loan cannot be repaid, and that there may be restriction on the free transfer of foreign exchange to the creditor country. Regulations also need to take account of the risk of currency mismatches. It should be noted that a deeper and more internationalized financial system can digest capital flows with less volatility in interest rates, the exchange rate and the prices of assets.

On the banking front, what is needed is that the participating countries' institutions should regulate themselves in light of the ratings they earn for their behavior in terms of solvency, liquidity, profitability, risk and efficiency. At the initial stage, it is the state that should do the ranking of bank instruments, so as to ensure that a clear and transparent methodology is established and will prevail. Subsequently, at later stages, this role can be handed over to independent private institutions, including the international rating agencies, particularly in the case where banks make use of international capital markets to fund themselves. Similarly, a key to stability in the banking sector is to ensure compliance with prudential standards on capital adequacy, consolidated supervision and the granting of banking licenses.

In addition, because it is not feasible or credible in most countries to withdraw the implicit or legal guarantee of deposits, the problems arising from abuse of such guaran-
tees must be minimized by stressing the role of proper banking supervision and regulation. It may be advisable to supplement that system by arranging for substantial involvement of foreign banks whose home countries practice serious and high-quality banking supervision and who have, moreover, open lines of liquidity to their parent institutions, if problems should arise.9

To the extent that banks from one country set up shop in another country, there is a need, as well, for the mutual exchange of information among the supervisors of banking and financial institutions in those countries. Although financial integration is easier when countries have liberalized their banking systems and have equipped themselves with a proper regulatory and supervisory system, it is essential that such regulation and supervision share certain basic principles in common, even if the banking structure in those countries is not necessarily homogenous. For example, in Argentina certain authorities are calling for the establishment of a “narrow banking” scheme, while full-service banks are expanding in Mexico. It is even possible for financial systems to coexist where development banks play an important role.

Nevertheless, despite the fact that member countries of an integration scheme do not share the same approach to banking regulation in all its details, integration of financial services in Latin America must not countenance, much less encourage, regulatory arbitrage—for example, the creation of tax havens and regulatory paradises. These tend to introduce a form of unfair competition and, moreover, to provoke instability for countries where supervision and taxes are taken seriously. Furthermore, financial integration must strive to avoid major tax distortions and substantive regulatory differences between domestic and international markets, since otherwise there will be significant financial disintermediation in the countries that are trying to integrate themselves financially. It must be stressed that incentives for local and foreign capital to seek out places with less onerous regulatory and taxation requirements must be resisted, because it is those places that present the greatest country risk and the least macroeconomic stability.

Financial Integration and Cross-Border Competition in Financial Services in Latin America

The long-term costs and benefits and the transition problems associated with external financial opening are well-known. Much less attention has been paid, however, to such aspects as analyzing the current status of financial integration in the region, and comparing it with the progress in the financial integration of Europe, which is now in its final process. Nor has there been much exploration of the differences between unilateral integration, in which a single country decides to open its financial markets to others, and the “integrationist” approach, in which a bloc of countries agree on the reciprocal opening of their domestic systems.

When examining the feasibility, speed and depth of the financial integration process in Latin America, we need to consider a number of institutional and structural questions, such as the magnitude of the differences in such variables in income per capita, country risk, the financial depth of capital markets, the degree of banking intermediation, and the type and quality of supervision in the various countries.

Note, for example, that GDP-per-capita ratios are much more similar, and relatively more stable, among the countries of the European Union than is the case in Latin America. Homogeneous data for 1993, shown in Table 2, show that the highest GDP per capita in the European Union

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TABLE 2

GDP Per Capita in 1993 (US$)

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was five times greater than the lowest, while in Latin America the gap reflected a factor of more than 21. Moreover, variability in GDP per capita in Europe was less than half that of our region, as can be seen from the coefficients of variation shown in Table 2.

As Table 3 makes clear, Latin America also shows significant differences in country risk: In 1996 the spread over LIBOR on external dollar-denominated bond issues with comparable maturities from Argentina, Brazil and Mexico was more than four times as high as that for companies operating in Chile. In the first four months of 1997, these spread differentials declined to between 3 and 3.5 times.

There are also sharp discrepancies in indicators of the scope and characteristics of domestic banking markets in Latin America. As can be seen from Table 4, internal credit from the banking system amounted to 58 percent of GDP in Chile, while the figure for Mexico was 48 percent; Brazil, 38 percent; Argentina, 26 percent; and Peru, only 11 percent. Again, the M2/GDP ratio was 29 percent for Chile, and around 23 percent in Brazil, Costa Rica and Mexico, while in Argentina and Peru it was half that level. And the ratio of demand deposits to GDP, which indicates the degree of banking intermediation, reached a maximum in Chile, at about 6 percent, while the lowest value—that for Argentina—was no more than 2 percent of GDP.

Indicators of soundness, management and competition in the banking industry, which are difficult to compare given the differences in certain accounting and regulatory practices, also show major discrepancies among the countries of Latin America. For example, as Table 5 shows, the ratio of capital to total assets for the Argentine and Colombian banking system is about 15 percent, while in Peru and Brazil it is around 9 percent; in Mexico it stands at 7 percent, and in Chile it is at slightly more than 5 percent. Overdue loans as a percentage of the total lending portfolio stand at 1 percent in Chile, and about 7 percent in Peru, Mexico, Brazil and Colombia, while in Argentina they are as high as 12 percent. Gross interest margins (as a percentage of assets) in Chile are one-half those recorded for Peru and Brazil, and less than half of those in Argentina, while support costs in Chile, again as a percentage of assets, are some 50 percent lower than in Argentina, Mexico and Peru, and less than one-third the level of those in Brazil and Colombia. Paradoxically, as can be seen from Tables 1 and 5, the Chilean banking system is the one with the lowest spreads and the highest degree of concentration; in contrast, Colombia, where there is the highest degree of market concentration, is the country with the lowest spreads.

Finally, the dynamism and strength of financial integration will also depend on the initial conditions in which the various countries find themselves. For example, the nature and the speed of financial integration are sure to be affected if one country has a problem of external overindebtedness or a banking system that is weak or in collapse. Considerations of this kind, as noted in the preceding paragraphs, have played and continue to play a major

<table>
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<tr>
<th>Country</th>
<th>1996</th>
<th>1997</th>
<th>Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>ARGENTINA</td>
<td>Companies</td>
<td>474.30</td>
<td>280.80</td>
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<td>Banks</td>
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<td>283.00</td>
</tr>
<tr>
<td>BRAZIL</td>
<td>Companies</td>
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<td>Banks</td>
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<tr>
<td>CHILE</td>
<td>Companies</td>
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<td>Banks</td>
<td>-</td>
<td>-</td>
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<tr>
<td>MEXICO</td>
<td>Companies</td>
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<td>Banks</td>
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<td>-</td>
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</table>

a. Refers to the differential between the yield on the bond issued and the relevant U.S. Treasury Bond.
b. Information through April 1997.
c. May 1997 long-term international country risk classifications in foreign currency.

Source: Bloomberg, Cruz Blanca and Standard & Poor's.
TABLE 4

Indicators of Financial Deepening

<table>
<thead>
<tr>
<th></th>
<th>M1/ GDP</th>
<th>M2/ GDP</th>
<th>DOMESTIC CREDIT/ GDP</th>
<th>DEMAND DEPOSITS/ GDP</th>
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</thead>
<tbody>
<tr>
<td><strong>ARGENTINA</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>1994</td>
<td>5.8</td>
<td>13.2</td>
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<td>5.9</td>
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<td></td>
</tr>
<tr>
<td>1994</td>
<td>6.8</td>
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<td>55.1</td>
<td>3.5</td>
</tr>
<tr>
<td>1995</td>
<td>4.9</td>
<td>24.3</td>
<td>38.0</td>
<td>2.1</td>
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<tr>
<td><strong>CHILE</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
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<td>8.6</td>
<td>28.0</td>
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<td>8.7</td>
<td>29.2</td>
<td>58.4</td>
<td>5.7</td>
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<tr>
<td><strong>COSTA RICA</strong></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td>12.4</td>
<td>27.5</td>
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<td>1995</td>
<td>9.2</td>
<td>23.9</td>
<td>ND</td>
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<td><strong>MEXICO</strong></td>
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<td>47.5</td>
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<td><strong>PERU</strong></td>
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</tr>
<tr>
<td>1994</td>
<td>5.1</td>
<td>12.5</td>
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<td>1995</td>
<td>5.7</td>
<td>13.2</td>
<td>11.2</td>
<td>3.3</td>
</tr>
</tbody>
</table>


role in explaining the slow pace of financial integration in Latin America. 11

Financial Integration in Practice

What we have been witnessing in Latin America in recent years is a de facto and rather hesitant form of "non-institu-
tionalized" financial integration. In effect, the 1990s have given rise to greater flows of capital within the region, with a particular emphasis on real estate investment. Particularly noteworthy here is the volume of direct investment that has been flowing from and to countries of the region, originating in or destined for capital market companies and institutions such as banks and pension funds. 12

These flows have been stimulated by the structural reforms, the greater openness and the privatizations that most countries of Latin America have embarked upon over the last decade.

In particular, there has been a remarkable growth in regional banking services networks offered both by Latin American financial groups and those from outside the region. Among the former, the Brazilian banks are prominent in the countries of Mercosur, Colombian and Venezuelan groups are active in their own countries as well as in Ecuador and Chilean financial groups are engaged in banking circles and pension funds in a number of countries of the region. The growing presence of non-Latin American banks is also striking, especially that of the Spanish banks, led by the Bilbao-Vizcaya and the Santander, which have been buying up domestic financial institutions, banks and non-banks alike. 13

Note that the more this kind of de facto integration proceeds among the same banks and/or groups in different countries, the more quickly local or domestic problems, including runs on banks, are likely to be transmitted regionally. This can only underline the importance of swift

TABLE 5

Financial Systems Indicators

(percentage)

<table>
<thead>
<tr>
<th>INDICATORS</th>
<th>MEXICO</th>
<th>BRAZIL</th>
<th>COLOMBIA</th>
<th>PERU</th>
<th>CHILE</th>
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<td>Spread</td>
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<td>Admin. Expenses/</td>
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<tr>
<td>Loans due/</td>
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<td>Capital/Assets</td>
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</tbody>
</table>

a. Information as of September 1996.
b. Indicators for the 17 largest banks.
c. Indicators for the 20 largest banks, except for "liquid assets/assets," which is the ratio for the entire system.
Source: Salomon Brothers.
and effective cooperation and coordination among national supervisory powers in Latin America, and the need to ensure that national regulations and rules are guided by similar principles and standards, so as to avoid arbitrage or “shopping” among regulatory systems.

Increasingly, we find that a greater number of Latin American countries and companies, financial or non-financial, are placing financial instruments, such as shares (ADRs in the United States, for example), bonds and convertible bonds on international capital markets, which are much more highly developed than those of the region. This kind of activity could be attempted within the region itself, but this would require national reforms in the institutional, taxation and legal areas, and greater harmonization of the relevant accounting data, of the kind that will allow Latin American securities markets, separately and independently, but in a complementary manner, to engage in local securities transactions.14

More generally, experience suggests that internationalization of the banking system goes hand-in-hand with trade liberalization and the growth of trade and investment abroad. At first, the banks’ international business tends to concentrate in external financial investments and in the financing of foreign trade among neighboring countries. Subsequently, and still within the foreign trade sphere, the banks will participate in financing linked to trade with third countries, and will then start to become involved in financing domestic companies that are “going international.” The most advanced stage of international banking is typified by making loans to non-residents, and for physical facilities located abroad.

To sum up, the integration of banking services in the countries of Latin America is still at a rudimentary stage,15 as a result of the many different monetary and exchange regimes, high and differentiated sovereign and exchange risk perceptions, the widely diverse solvency situations of the banking systems, and a lack of understanding and coordination in regulation and supervision among the region’s countries. Even efforts at trade integration are proceeding only slowly. For all of these reasons, it is unrealistic to expect a powerful movement toward Latin American financial and banking integration in the foreseeable future, beyond the developments discussed earlier. This is not to say, however, that we should not press ahead with institutional, legal, regulatory and accounting reforms aimed at eventually achieving such an objective.

**Mercosur and NAFTA**

As noted above, Latin America has made little progress toward financial integration as such, and is still very much in a learning process. Until now, the region’s financial internationalization has proceeded essentially through a series of unilateral openings, despite initiatives such as NAFTA and Mercosur, and the worldwide trend toward the formation of bid trading blocs.

**Mercosur** is a trade agreement among Argentina, Brazil, Paraguay and Uruguay, to which Chile has recently adhered, that has had the essential objective of reducing tariffs and other barriers to foreign trade. That agreement does not include the services sector as an area of negotiation.

**NAFTA** is a much more comprehensive agreement, since the treaty includes principles and provisions governing investment and financial services. With respect to the latter, the key clauses of NAFTA seek to ensure that foreign providers of services can have access to local markets, while at the same time maintaining certain principles of prudential regulation.

Generally speaking, NAFTA covers cross-border trade in financial services, including banking, insurance and securities intermediation products. That is to say, it allows foreign providers to offer such services without the need to have a physical presence in the country of destination. In a manner that is integrally linked to cross-border trade in services, NAFTA seeks to ensure the free flow of capital. In addition, NAFTA protects the right of establishment—i.e., the ability of suppliers from one member country to have a commercial presence in another member country—and guarantees national treatment for the physical installation of a financial institution in another country. To put it another way, it forbids discrimination on the basis of the origin of the investment. In this sense, it applies the principle of most-favored-nation.

Yet, notwithstanding these principles, which are intended to open the way to trade and participation in each other’s financial markets, NAFTA also provides for safeguards, either by exceptions or by reservations, to protect each country’s approach to regulation and to macroeconomic stabilization.16

The need to preserve the differences among the various regulatory approaches was a key factor in the financial services negotiations under NAFTA. The pertinent clause of the treaty ensures that member countries retain their autonomy with respect to prudential regulation and to tak-
ing stabilization measures that affect the financial sector. Since the regulatory approaches of the countries involved were very different, there was no possibility of arriving at full harmonization, as the members of the European Union have been able to do, for example.

While the focus of NAFTA is fairly liberal with respect to cross-border trade in financial services, it states that the right of establishment may be exercised under any desired legal form, whether as a branch, a subsidiary or an affiliate—but within the legal and regulatory framework of the host country.

In general, free-trade agreements in the financial services sector may involve distinct levels of commitments by member countries, ranging from freedom for cross-border trade, the right of establishment and national treatment, to the creation of a common market with fully harmonized regulations.

Freedom to conduct cross-border trade in financial services was not an issue of debate in the NAFTA context, mainly because both Canada and the United States already maintained a liberal approach to capital movements. In the absence of exchange controls, residents of one country are at full liberty to make financial and non-financial investments in other member countries. What obstacles there are in this area arise essentially from the lack of tax harmonization and from certain exchange controls that Mexico has maintained, despite the thorough-going process of external opening in which it has engaged.17

Consequently, the negotiations on financial services focused on the right of establishment subject to national treatment—i.e., on allowing foreign providers of financial services to have a physical commercial presence, subject to the same rules as those governing domestic financial institutions in the country concerned.

Although the elements discussed here are certainly encouraging the more direct integration of financial services in the region, both Mercosur and NAFTA are treaties of limited scope both in terms of their field of application and their country coverage. If the “Americas Initiative” becomes a reality, we hope that the process of financial integration will be deepened and accelerated.

**Regulatory Principles To Promote Greater Financial Integration in Latin America**

Worldwide, moves toward multilateral liberalization of trade in services, and in particular those of a financial nature, have fallen far behind progress on trade in goods.18 The Uruguay Round was the first occasion that services became an important feature of efforts to achieve openness and internationalization.

The most important multilateral accord affecting international trade in this area has been the OECD agreement on codes for liberalizing capital movements. These codes call for the progressive liberalization of capital flows and financial services, and national treatment for foreign service providers. In recent years, OECD members have made drastic changes to their domestic legislation in order to comply with the spirit of these codes.

The European Community, for its part, has agreed on the free right of establishment in its members' markets, a liberalized regime for the delivery of cross-border financial services, and the harmonization of the principal rules of regulation among member countries. To establish a commercial presence in any country of the Community, a bank of any member countries needs only one license—i.e., a home-country authorization to operate regionally. For purposes of supervision, the regulatory principles of the home country prevail, and there is mutual recognition of regulatory regimes among all EC members. There are also agreed standards relating to capital adequacy and transparency rules.

More generally, in the developed world, and particularly in Europe, the various ways of conducting international trade in banking services are governed by the following rules: In the case of cross-border banking, the rules of the home country prevail; in the case of subsidiaries in another country, the rules of the host country prevail; and in the case of branch banks, the rules must be harmonized.

In Latin America, although for the moment, as explained, there can be no harmonization of regulations as in Europe, any real progress toward financial integration must presuppose certain basic, shared elements of regulation.

In the first place, regulation and supervision must be conducted with a view to maintaining a solvent, stable and efficient financial and payments system. Additional official objectives must be to keep runs on banks to a minimum and to reduce as far as possible any implicit or explicit guarantees on bank liabilities. Finally, the authority must be constantly on guard to maintain public confidence in the financial system.

Another important element is that the banking system must be subject to a series of prudential regulatory mea-
sures. Banks must maintain an adequate level of capitalization, consistent with the risks they incur. These risks may be of various kinds—for example, credit risk, currency risk and interest-rate risk. For purposes of quantifying these risks, account must be taken of net positions, exchange-rate volatility and asset prices.\textsuperscript{19} Even in the case of complicated derivatives like options, capitalization must be required to reflect all the dimensions of risk.

An adequate level of capitalization represents a safety cushion for coping with potential losses and for avoiding moral hazard and risk. At the present time, the Basle capital adequacy requirement for banks of 8 percent is a standard that is frequently applied internationally. Yet that standard must be regarded as a minimum. In particular, given the greater volatility of Latin American economies and the vulnerability of their financial systems, banks engaged in the process of financial integration should have a capital adequacy indicator of at least 10 percent. These higher capital requirements must not give rise to differences in the weighting of risk factors for countries of the region, since that would constitute manipulation that would allow capital requirements to be altered indirectly. Currently, Argentina calculates capital requirements as a function of asset risk, including market risk, while Brazil demands liquidity compatible with the risk structure of assets, and Chile requires a maximum debt-to-capital ratio of 20.

Regulation also should limit the concentration of assets and transactions with related parties, so as to enhance diversification and minimize conflicts of interest. Loans to related borrowers should be subject to strict limitations, to capital deduction rules or to the need to collateralize such loans. In any case, the terms and conditions of such loans must be based not only on current market factors, but also on medium- and longer-term fundamentals.

In addition, banks, for the most part, are exposed to a term conversion process that makes them relatively illiquid. Cash-reserve requirements can protect the payments system and induce banks to act prudently in the face of possible withdrawals of deposits. In Argentina a cash reserve of 18 percent is required for demand deposits and for term deposits maturing within 3 months, and this percentage is reduced gradually to zero for transactions of more than one year. In Brazil, demand deposits have a 75 percent reserve requirement, term deposits 20 percent, and savings deposits 15 percent. In Chile, the cash-reserve requirement for demand deposits in domestic currency is 9 percent, and for term deposits and other term obligations 3.6 percent, except for obligations of more than one year, which are not subject to cash reserves. In addition, any deposits or obligations in foreign currency are subject to a 30 percent cash reserve. In any case, the elements that must be considered in managing liquidity effectively will include proper information systems, an analysis of net funding requirements under different scenarios and diversification of funding sources.

The institutional arrangements governing the payments system must be such as to minimize periods of counterparty risk that could have a negative impact on the public finances. In particular, an efficient payments system should eliminate any credit risk to the central bank. Payments should be made against instantaneous verification that funds are available in the current accounts deposited in the banks and in the central bank.

Generally speaking, banks keep a combination of marketable assets and others, such as placements, for which there is no liquid market. In order to foster self-regulation and transparency, assets should be valued at market prices. Placements should be valued according to the repayment prospects of the credit, by means of provisioning requirements, structured on the basis of the expected cash flow from the borrower and the quality of the guarantee.\textsuperscript{20} The frequent valuation of a bank’s assets at market prices, regular risk classifications of the liabilities they issue, the presentation of monthly financial statements and verification of the quality and accuracy of accounting information by external auditors are all ways of providing transparent information to the market; this is a key aspect of self-regulation. The presence of international rating agencies and external auditors in different countries should facilitate the standardization of information and thereby stimulate the region’s financial integration.

The process of granting licenses needs to strike a delicate balance between being overly generous, which can lead to problems of management and solvency, and being too restrictive, which can discourage competition in the industry. In any case, the process must be selective, with objective rules and clearly identified barriers to entry. In particular, it is important to avoid bouts of destructive competition and the adverse selection of new bank owners. The foregoing presupposes a clear understanding that the costs of entry to and exit from the banking system are very
different. As is well known, a bank's exit from the market can entail negative externalities and can be very costly.

In conclusion, there can generally be no such thing as free access to the banking business. This is true for reasons that are both microeconomic (to avoid the adverse selection of owners) and macroeconomic (since a banking market in which many entities are competing may tend to fall into generalized insolvency, with consequent problems for the entire system). Thus, in Chile, for example, the granting of new banking licenses has in effect been closed since 1990, and the authorities have complete discretion over the issuing of any new ones, while in Uruguay new licenses are limited to no more than 10 percent of the number of banks in existence at the end of the previous year. Some countries, such as Brazil and Mexico, still maintain restrictions on foreign ownership. In Brazil, foreign participations require prior approval through a presidential decree, and the number of foreign bank branches is de facto limited to the count at the present time. In Mexico, foreign investors may own up to 30 percent of a bank's capital, a restriction that is being gradually relaxed for NAFTA member countries.

The scope of activities in which banks engage should also be kept under review, so as to avoid overextension of the safety net and to limit the risks arising from new activities.

With respect to monitoring, experience suggests that supervisors should rely on a combination of reports of the "Camel" type, which describe capital adequacy in terms of the risks assumed, the quality of assets and management, and the structure of revenues and liquidity, with on-site inspections, which will provide for clarity with respect to the quality of the portfolio, the institution's management capabilities, and the quality of the internal control systems in place.

As banking groups begin to take on new financing activities, whether in the domestic arena or abroad, it becomes increasingly important to exercise consolidated supervision that will provide a comprehensive overview of the risks assumed. Supervision on a consolidated basis limits the risks of "contagion" arising from inter-group positions, significant common positions of the group, psychological contagion and possible double-leveraging of capital. In effect, loans and other related group activities, the use of capital for purposes of multiplying the group's dealings and its debt, and the risk of over-concentration of loans and assets in certain activities by various companies within the group—all can increase the risk and vulnerability of any bank's belonging to the group. Moreover, if the market regards the conglomerate as a single unit, then it is futile to try to keep its dealings separate, and consolidated supervision becomes not only necessary but urgent. In these cases, a functional regulation is not enough, since the risk of the conglomerate as a whole is greater than the sum of the risks of its component entities because of the "systemic" risk involved. The failure to exercise consolidated supervision over offshore banking activities involving the banking systems of Ecuador and Venezuela was one of the prime causes of the recent financial crises in those countries.

In addition to the foregoing, when problems arise with certain banks, national regulations should provide for a safety net with a set of instruments (carefully limited to reduce moral hazard) such as guarantees for demand deposits and means of injecting liquidity into the banking systems, so as to ensure a greater degree of stability in the financial system. Schemes of this kind, however, can increase the risk of imprudent behavior on the part of the banks. To limit this risk, the insurance offered can be for partial coverage only and can carry a premium that varies with the risk incurred, while liquidity credits can be made available only against collateral of the lowest risk. In addition, regulation must provide for a set of corrective actions in the case of banks that are undercapitalized, whereby shareholders and/or creditors can be called on to provide preventive capitalization and so minimize the risk of bankruptcy. In extreme situations, where a banking entity is no longer financially viable, the supervisor can and should encourage a merger or find another bank to take it over. In the end, the authority must have the power to declare a bank insolvent and to wind it up if necessary, so as to protect the stability of the rest of the financial system. The guiding principle should be that losses, just as much as profits, are for the account of the private sector, at least for the former shareholders, and to some extent for the creditors and the depositors. And when fraud is involved in a bankruptcy, the owners should be liable with their personal assets. This principle will minimize situations of moral risk.

To summarize, it is essential, in our view, that Latin American countries adopt jointly the regulatory principles we have outlined. Nevertheless, given the great differences to be found in organization and institutional structure of the financial and banking industry, and in the cyclical economic conditions facing the industry in the various coun-

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tries of Latin America, we do not see it as feasible to harmonize specific rules. Indeed, it is very difficult to achieve complete harmonization in the fields of banking activity, the banking structure, the treatment of branches abroad and the safety of deposits, to cite just a few examples.

With respect to the internationalization of the banking industry through cross-border credit transactions, this demands regulatory features that are different from those that apply to domestic lending. While it is true in theory that opening up the spectrum of business possibilities for the banks by authorizing credits abroad should allow them to diversify risk more effectively, it must be remembered that operations of this kind are exposed to country risk, exchange risk and differences in legal, regulatory and supervisory treatment.

Pursuing the issue of internationalization, while an individual debtor's risk can be measured on the basis of the expected flow of repayments and the quality of the guarantees offered, an additional degree of caution is needed in light of the increased difficulty of executing those guarantees and the possible divergence of the currency in which the debtor's revenues are earned from that in which the loan is denominated. In addition, limits are required to ensure proper diversification by country, and provisions for country risk are needed that will take account of the political risk and the transfer risk involved in international transactions. Finally, there are financial risks to be covered, in particular the risks of currency mismatching and interest-rate risks.

When it comes to the physical establishment of subsidiaries, branches and affiliates of financial groups, a series of regulatory measures are required, such as consolidated supervision by the home country, which can take an overview of the risk situation of the holding or parent company and all the activities flowing from it. Such regulation must also ensure that the consolidated capital is adequate in light of the risks to be undertaken, and that authorization has been obtained from both the home and the host country. At the same time, it must enforce the principles of integrity and solvency of the owners. In particular, bank shareholders must demonstrate that their financial and legal conduct are unimpeachable and that they are economically sound enough to undertake banking activities, to minimize the risk of adverse selection of controlling shareholders of a bank, and allow a reasonable assurance that the institutions will be managed seriously and professionally. Moreover, and even more important, there should be supervision agreements between the member countries of any financial integration system that provide for the smooth and timely exchange of information, and allow for on-site inspection of branches and subsidiaries by the home-country authorities, so that they can maintain effective supervision.

Most of these principles have been adopted by the G-10 within the framework of the Basle Committee on Banking Regulations and Supervisory Practices.

Consideration also needs to be given to the aspects of taxation, exchange controls and investment protection. Particular care should be taken in dealing with "tax havens," which generally exercise only lax supervision, and where it is common not only to conduct banking activities that are prohibited at home, but to evade domestic regulations altogether. Clearly, it is important to avoid regulatory arbitrage associated with situations of this kind. In this respect, international agreements need to be sufficiently broad in their geographical coverage that they can avoid regulatory competition with countries that do not share these principles. Otherwise, a potentially explosive situation could develop that would threaten the stability and solvency of the banking systems of the countries that are members of the agreement.

**Summary and Conclusions**

Globalization is one of the trends that has shaped the development of the world's economies in recent times. Latin America is no stranger to this phenomenon, particularly in light of the institutional and structural reforms it has undertaken, to varying degrees, and the steps it has taken to open its economies. In particular, the region has moved decisively to integrate itself into world capital markets, by participating more actively in the flow of foreign direct investment and by placing its shares and bonds on international financial markets.

In terms of economic integration, despite the progress that has been made, Latin America is clearly well behind Europe. Europe's successful experience shows that the changes associated with the processes of financial integration make themselves felt only gradually, and only after commercial integration has been achieved. More specifically, the case of Europe demonstrates that economic integration is a process in which countries must advance step by step, dealing first with trade, then with finance, and
finally, at the most advanced stage of integration, with monetary union.

The imminent creation of the European Monetary Union, taken together with the various country agreements and subregional integration schemes between Latin America and the European Union, and the growing participation of Latin American countries in the work of the OECD and the Bank for International Settlements (BIS) in Basle, represent an excellent opportunity for the region to internalize the institutional, juridical, normative, regulatory and economic aspects of financial integration.\(^{23}\)

A key element in any process of financial integration is the ability to achieve and sustain basic macroeconomic equilibrium. This is a necessary condition for strengthening domestic financial systems, and to establish that minimum degree of stability that is required to conduct effective international trade in financial assets and services, particularly with respect to country risk and exchange risk.

This does not call for full policy coordination, but rather a strong and real commitment on the part of the members of any integration scheme to achieve and maintain macroeconomic stability. As a minimum, it would seem desirable and appropriate for such countries to move forward in the area of coordinating their macroeconomic information. A regional or subregional agency could monitor and publish regular reports on such information, so that countries and their banks can take it into account in their plans for "going international."

Another prior condition for financial integration is domestic financial liberalization, which must, of course, go hand-in-hand with a strict and efficient system of banking supervision and regulation.

To make progress toward greater financial integration it is essential, on the one hand, that there be a smooth and timely reciprocal flow of information among the region's national supervisors and, on the other hand, that they share the basic prudential and regulatory principles adopted by the Basle Committee on Banking Regulations and Supervisory Practices. These relate in particular to the adequacy of capital bases and to consolidated supervision. Yet given the differences in the institutional and organizational structure of Latin America's financial sectors—and in the initial economic conditions facing them—it would seem unrealistic to try to harmonize the specific points of financial and banking rules. The exchange of information among authorities and compliance on the part of national banking systems with the principles cited above are preconditions for making Latin American financial integration viable in the first place and for reinforcing it subsequently.

In terms of the feasibility, speed and depth of the financial integration process in Latin America, we must take into account the differences in such variables as income per capita, country risk, the financial depth of capital markets, the level of bank intermediation and the methods and quality of banking supervision in different countries. Moreover, the dynamism and durability of financial integration will also depend on the initial conditions prevailing in those countries. For example, the shape and speed at which financial integration proceeds cannot be immune to situations such as those where one country has a problem of external over-indebtedness or a banking system that is on the verge of collapse. There is no doubt that considerations of this kind have been and continue to be a major factor in explaining why financial integration in Latin America has made such little progress.

What we are witnessing today is a kind of non-institutionalized financial integration in Latin America. The 1990s have seen a surge of capital flows within the region, with a particular emphasis on real estate investment. Especially noteworthy here is the volume of direct investment that has been flowing from and to countries of the region, originating in or destined for capital market companies and institutions such as banks and pension funds. It is noteworthy that this process has taken place through their owners, whether individuals or corporations, rather than through the institutions themselves, given the legal restrictions in place and the lack of consolidated supervision. Moreover, there has been a recent reawakening of interest on the part of non-Latin American banks, particularly from Spain, in acquiring domestic capital market players and in taking an active part in the region's financial and banking business.

On another front, an increasing number of Latin American countries and companies, financial or non-financial, are placing financial instruments such as shares (ADRs in the United States, for example), bonds and convertible bonds on international capital markets, which are much more highly developed than those of the region. This kind of activity is beginning to appear within the region itself, but if it is to become deeper and more widespread, it will require national reforms in the institutional, taxation and
legal areas, and greater harmonization of the relevant accounting data.

Until now, the region's financial internationalization has proceeded essentially through a series of unilateral openings, despite initiatives like NAFTA and Mercosur, and the worldwide trend toward the formation of big trading blocs. The integration of banking services in the countries of Latin America is in fact in its early stages, primarily as a reflection of high and differentiated sovereign and exchange risk perceptions, the widely diverse solvency situations of the banking systems, and a lack of understanding and coordination in financial regulation in general (and banking supervision in particular) among the region's countries. It would be a clear step forward in the process of financial integration if countries would allow and facilitate reciprocal access to their markets by guaranteeing the right of establishment to foreign banks on the condition of national treatment. Yet it must be recognized that even trade integration schemes in Latin America have run into roadblocks, which makes it seem unrealistic to think that full financial and banking integration can be achieved any time in the near future. This is not to say, however, that we should not move ahead with the kind of institutional, legal and regulatory reforms that that objective will demand. Latin America's present economic outlook is broadly favorable, since we can expect that its current business and trading dynamism will persist, that inflation will be brought further under control and that economic reforms will be reinforced. In addition, the relatively low degree of banking intermediation in the region, the high returns recorded in the financial sector and the growing opportunities for doing business on a regional scale are all factors that augur well for regional financial integration. Nevertheless, whatever the degree of progress it may make in achieving financial integration, Latin America must press ahead in its national efforts toward stabilization and structural reform, in order to provide a solid underpinning for the long-term sustainability of its economies. A responsible approach to domestic macroeconomic management, the encouragement of domestic savings, and attention to the growth and proper funding of capital formation are essential preconditions for Latin America's economic development.

Notes

1. In strictly economic terms, the European Monetary Union will help to highlight even more clearly the role of economic blocs in the international economy. Those blocs, because of their size and nature, should be less sensitive to external economic repercussions on their development and their policies. This, in turn, may lead to their economic cycles being increasingly out of phase, and it could induce greater exchange- and interest-rate volatility among the major currencies, including most certainly the dollar and the euro. Consequently, Latin America will need to prepare itself to face greater instability in coming years, both in the prices of the major currencies and in international interest rates.

2. The theory and practice of economic integration have focused almost exclusively on the implications for the allocation of resources. With the sole exception of the analysis and debate that surrounded the question of optimum currency zones in the 1970s—and that never had much of an impact on the integration effort, although it may have been helpful in refining some individual countries' exchange systems—there has been little analytic or empirical attention paid to the macroeconomic, financial and monetary effects of integration.

3. There are countries within the region that have introduced policies that are formally very "liberal and open" with respect to the capital account of the balance of payments, and that, nevertheless, have recorded higher domestic interest rates and greater differentials against international rates than other countries that embarked on a more gradual and selective strategy of financial opening. This paradox seems to be explained primarily by their greater degree of country risk, or by the devaluation that they may have practiced. It is by no means clear, therefore, that a swift and wholesale financial opening will allow a country to generate greater confidence among international creditors and foreign investors, or to break its way effectively and permanently into international capital markets.

4. The cases of Mexico in 1994 and the Czech Republic and Thailand in 1997 bear witness to the importance of having sustainable current account deficits as a precondition for effective and durable financial integration.

5. Recently, because of the problems surrounding Brazil's adoption of special short-term import financing measures, Mercosur agreed to set up a Macroeconomic Coordination Group for the bloc and to work through it on the preparation of a scheme of this kind.

6. An initiative in this direction was considered in New Orleans in 1996, during the first meeting of hemispheric finance ministers, where the countries attending agreed to adhere to the information disclosure standards of the International Monetary Fund.

7. Guillermo Calvo, among other authors, has dealt with this topic.

8. This is because, during such episodes, domestic interest rates will be much higher than normal, which leads to lower effective repayments of credits from the banking system. This means that the banks' debtors no longer face, in practice, any budgetary restraints on their spending decisions, and monetary policy loses most of its effectiveness.

9. Table 1 shows that foreign banks in selected Latin American countries have a share of between about 22 percent and 30 percent of the credit market, except for Brazil, where at present
foreign banks account for only 7 percent of total credit from the banking system.

10. For example, while Chile and Mexico apply monetary correction and have financing indexation mechanisms, this is not the case in Argentina or Brazil. There are also different rules regarding credit arrears for purposes of classifying overdue loans in each of these countries. When it comes to the banks' financial investments, in Chile these are valued at market prices if they are for more than one year, and at cost of acquisition if they are short-term; in Argentina, on the other hand, short-term instruments are valued at market prices, and those of more than one year are recorded at their cost of acquisition. In Mexico, they are recorded at their cost of acquisition, while in Brazil they are carried at market value, whatever their term. With respect to the taxation of credit, Chile imposes a stamp tax, Argentina applies the VAT, and in Brazil there is a so-called financial operations tax, which varies depending on the maturity of the instrument. In Mexico, loans are not subject to any taxes at all.

11. Note, however, that institutional and structural differences, and discrepancies in economic cycles and starting conditions, can also present opportunities and foster trade in the financial area.

12. Note that for most of the region's financial institutions, including the banks, this process has taken place through their owners, whether individuals or corporations, rather than through the institutions themselves, given the legal restrictions in place and the lack of any properly consolidated supervision.

13. The Grupo Santander, for example, has interests in 14 Latin American countries, representing an investment of US$3.5 billion and accounting for more than 50 percent of the group's entire investment outside Spain; its Latin American assets total some US$45 billion, and has created jobs for more than 43,000 people in the region.

14. Mexico is about to open its stock market to foreign companies that quote their shares in the United States. Similarly, Argentina and Mexico, following the recent example of Brazil, are the two countries in the region that are planning to introduce the use of certificates of deposit for shares. In Chile, the Congress is currently considering legislation for the Bolsa Internacional, an international stock exchange that will allow foreign securities to be traded locally.

15. By way of example, despite the sharp growth in international trade, electronic transfers among banks in different countries are not done directly, but via the United States, much the same as happens in the region's air transport business.

16. While it is no doubt desirable to allow a degree of national maneuvering room, it must be recognized that this may slow progress toward full financial integration.

17. Latin America is still a long way from free trade in cross-border capital movements, because several countries—e.g., Brazil, Colombia and Chile—apply restrictions on capital inflows.

18. Recently the Basle Committee on Banking Regulation and Supervisory Practices published a paper that sets out 28 "Core Principles for Effective Banking Supervision." These principles were developed by the countries belonging to the G-10, in collaboration with the supervisory authorities of 15 emerging economies, including Brazil, Chile and Mexico. The paper provides a useful frame of reference for supervisors and banks worldwide.

19. Increasing competition between banks and other types of financial institutions, and the growing sophistication of new banking products like derivatives, make it essential that banking risks be managed in a professional way, both by the banks and by the supervisors.

20. Nevertheless, under some circumstances (typically in the growth phase of the business cycle or when some key prices, such as the exchange rate, are out of line with their fundamental determinants), the market may send "distorted" signals, either directly or in relation, for example, to the value of the guarantees. One way to alleviate this problem is to require banks to put a minimum percentage of their own capital into the financing of an investment project and/or into the acquisition of an asset.

21. The growing interrelationship between banks, insurance companies, pension funds and securities dealers requires a consolidated approach to supervision that will deal squarely with the main institutional challenge, which is to coordinate the financial system's various supervisory bodies.

22. On this point, it is important that national legislation and legal systems should be equipped to deal promptly and effectively with the particular features of financial activity in order to resolve crises and/or bankruptcies.

23. Such exchanges of information will of course have to overcome the obstacles presented by the banking-secrecy laws that exist in every country.


25. To this end, it would be useful for the region's central banks to participate more fully and actively in the regular BIS meetings to which they are invited. It was only recently that Brazil and Mexico became the first two Latin American countries to join the BIS as members. The BIS could become a forum for examining questions about exchange rates, monetary and financial issues among Latin American monetary authorities, and for sharing experiences with other emerging economies. In addition, the BIS offers the chance to compare knowledge and practices with European countries; this could help countries of our region to internalize the lessons of European financial integration. Similarly, Latin American countries are increasingly active in the various workings of the OECD in Paris, and are maintaining close ties with the European Union through the Commission in Brussels, which has played and continues to play a major role in Europe's financial and monetary integration.
X. Macroeconomic Policy Coordination
Free Trade and
Macroeconomic Policy

BARRY EICHENGREEN

WHAT ARE THE CONNECTIONS BETWEEN THE ESTABLISHMENT OF A FREE-TRADE area and the conduct of macroeconomic policy? Most economists' instinctual answer would be "none." Trade theory and policy tend to be taught in one part of the international economics curriculum, open economic macroeconomics in another. Trade theory concerns itself with the allocation of resources between sectors producing importables, exportables and nontraded goods, open-economy macroeconomics with financial variables like inflation and exchange rates. Rarely do the twain meet.

They should meet, of course, as the instructor struggling through the standard syllabus is reminded each semester by the outspoken student at the rear of the lecture hall. Inflation and exchange rates, not to mention cyclical fluctuations, affect resource-allocation. Trade transmits disturbances to inflation and unemployment in a variety of models. Even a moment of reflection will make clear that the connections between trade and the macroeconomy run in both directions.

In this paper I seek to put some structure on the outspoken student's intervention, asking questions like the following: To what extent must participants in an FTA coordinate their macroeconomic policies in order to fully reap the benefits of trade? Are there political or economic mechanisms that, in the presence of inadequate policy coordination, prevent the gains from trade from being realized? Should countries hesitate to negotiate a free-trade agreement with a potential partner who has yet to put in place sound and stable macroeconomic policies, or should they disregard the consequences of those macroeconomic policies for bilateral real and nominal exchange rates and enthusiastically trade with such a country like any other? What is the evidence on these questions from existing free-trade areas, and what are the implications for Mercosur?

In the first section I consider two channels through which erratic, uncoordinated policies might prevent the full gains from trade from being realized: that they might give rise to exchange-rate and relative-price fluctuations that discourage producers from allocating resources along lines of comparative advantage; and that they might give rise to exchange-rate and relative-price fluctuations that encourage domestic agents to lobby for protection. Both theory and empirical evidence provide support for the operation of these two channels; they suggest that the first effect, while significant, is likely to be small, but that the second effect may have major consequences.

In the second section I turn the question around and consider the implications of trade for macroeconomic policy. Much recent research has explored the implications of capital mobility for monetary and fiscal policy. Here I
revisit the prior question and the older literature on the implications of trade openness for the conduct of stabilization policies.

The next section considers the relevance of these arguments to Mercosur. Despite the FTA's short history, experience with Mercosur confirms that real exchange-rate fluctuations, which give rise to sharp shifts in competitiveness and sudden import surges, threaten a protectionist backlash against trade liberalization. At various times these pressures have been transmitted from and felt by both of the two large partners in the FTA, Argentina and Brazil—most prominently in trade in motor vehicles and components, but in other sectors as well. To date, the protectionist pressure induced by macroeconomic instability has not seriously undermined political support for the FTA, but the danger remains.

For those concerned with the connections between freetrade areas and macroeconomic policy, the European Union (EU) is an especially pertinent case. The Treaty of Rome, under which the members of the European Economic Community committed to establishing a customs union, singled out the exchange rate as a matter of "common interest." Movements toward freer intra-EU trade have consistently been accompanied by efforts to coordinate macroeconomic policies more closely. While this dynamic is particularly evident in the current drive for monetary unification, concern with macroeconomic policy coordination in general and exchange-rate stability in particular has been a constant of EU history. The fact that the EU is the most extensive and successful free-trade area (and, for those who insist it is more than a trading arrangement, that its customs union has led to even deeper forms of integration) suggests that the coordination of macroeconomic policies may be essential to the success of a regional trade arrangement. The fourth section takes a detailed and ultimately somewhat skeptical look at this proposition.

With this analysis in hand, section five returns to the core question: In how much and in what kind of macroeconomic policy coordination must the Mercosur countries engage to reap the full gains of regional integration? My conclusions are follows: In the short run, the need for macroeconomic policy coordination is limited. But as Latin American financial markets become still more open and integrated, and as competition between the manufacturing and service sectors of the Mercosur economies grows even more intense, the potential for a protectionist backlash due to currency fluctuations will mount. This will encourage efforts to coordinate exchange-rate and macroeconomic policies among the member states of the FTA. But the options for more closely harmonizing the macroeconomic policies of the Mercosur countries are relatively limited. Feasible policy coordination is likely to focus on harmonizing policy rules and guidelines. This could involve, for example, the adoption of common inflation targets for monetary policy. More ambitious policy-coordination exercises are unlikely to be successful, however.

The final section concludes by returning once more to the connections between free trade and macroeconomic policy.

**Policy Instability and Trade**

The impact on trade of macroeconomic policy generally and macroeconomic policy instability in particular is likely to depend on the form taken by that instability. Still, for a range of plausible specifications, the uncertainty associated with policy instability and the protectionist pressure it evokes may prevent the gains from trade from being fully realized. Although results vary by model, both theory and empirical evidence point in this direction.

**Theory**

The earliest partial-equilibrium analysis of the impact of policy-induced exchange-rate uncertainty on trade is Ethier (1973). Using a mean-variance specification of the expected utility of a representative firm competing atomistically in international markets, Ethier showed that the volume of trade declines with the level of exchange-rate uncertainty. Hooper and Kohlhagen (1978) demonstrated subsequently that the essential result carries over to monopolistic competition.

Neither of these models took general-equilibrium repercussions into account. Perhaps the simplest general-equilibrium model that can be used to analyze the impact of policy instability on trade is that of Kemp and Liviatan (1973), who consider a two-country Ricardian model in which both countries typically specialize completely, producing and exporting one of two traded goods. They assume that the relative price of the two goods (the terms of trade) fluctuates randomly. We can think of the terms-of-trade fluctuations as reflecting macroeconomic policy-instability abroad. Intuitively, in periods when Argentine inflation is relatively high and variable, Brazil's terms of trade should be relatively unstable.
To provide a channel for relative price fluctuations to affect trade, it is assumed that production decisions occur prior to the resolution of uncertainty (on the basis of expectations) and that trade and consumption decisions occur afterward. Consumers are assumed to have standard quasi-concave preferences and to be risk-averse.

It simplifies matters to start with the special case where producers are risk-neutral. Given this assumption, price uncertainty does not affect output: Producers maximize expected profits, and our Ricardian economy still specializes completely in production. This is not a happy situation for consumers, however. The relative price of the exportable good can turn out to be high or low. If its price is very low, it will turn out to be even more expensive to purchase the imported good ex post than it would have been to produce it at home ex ante. In this state of the world the utility of domestic residents is very low. If they are sufficiently risk-averse, they will want the insurance of some domestic production of the importable. This makes them better off in states of the world where the relative price of the importable turns out to be high (specifically, higher than the ex ante marginal—and, given the Ricardian assumption, average—rate of substitution between exportable and importable goods), and worse off in states of the world where the relative price of the importable turns out to be low. Because they are risk-averse, they attach particular value to utility in the state of the world where the terms of trade and national income are unfavorable; hence, they wish to insure themselves by having some domestic production of the imported good. They will lobby, therefore, for government policies to limit imports and otherwise encourage the import-competing sector. The protectionist pressure induced by price uncertainty will cause the pattern of domestic production to resemble the pattern of domestic consumption more closely. Specialization along lines of (ex ante) comparative advantage will be limited, as will the volume of trade.

If we now add risk-aversion on the part of producers and assume that they have no recourse to financial markets or opportunity to establish foreign subsidiaries, they will respond to uncertainty by producing a diversified portfolio of both exportables and importables to hedge against relative price risk. The degree of specialization will be less than in the absence of uncertainty even if we allow for self-insurance by consumers. It is not, in general, possible to say what happens to the volume of trade, although under plausible conditions it is lower than in the certainty case.

Thus, the simplest model yields strong conclusions. Relative price uncertainty due to policy instability may discourage risk-adverse producers from specializing along lines of comparative advantage. Even if firms continue to specialize, consumers may lobby for protection for the import-competing sector. Under plausible conditions the volume of trade will be lower than otherwise. A macroeconomic policy that creates relative price uncertainty may then be incompatible with fully exploiting the gains from trade.

**Evidence**

There is no body of empirical work directly concerned with policy instability and trade. But literature on related subjects speaks obliquely to the question. I consider the works concerned with three links in the chain connecting macro policy to trade and trade protection: the impact of exchange-rate variability on trade, the impact of policy instability on the exchange rate and the liking of protectionism to policy instability.

The findings of the literature on exchange-rate variability and trade would seem to be contradictory and inconclusive. In fact, however, the most recent wave of (third-generation) studies yields strong, consistent conclusions. The first wave of methodologically rudimentary studies reported implausibly large effects. Thus, Cushman's (1983) estimates for OECD countries in the 1970s implied a 7.2 percent decline in the level of intra-EC trade due to exchange-rate variability. The second generation of work (e.g., IMF 1984, Gotur 1985) subjected these specifications to sensitivity analysis and established that their results were not robust; this did much to inform the skeptical view of the relationship. In recent years, a third wave of more methodologically sophisticated studies has documented the existence of small but robust negative effects of exchange-rate variability on trade. Bini-Smaghi (1991), employing a dynamic specification, finds evidence of a small but consistently significant negative effect. Chowdhury (1993) obtains essentially the same result from an error-correction model suited to the stochastic properties of the relevant time series. Arize (1996) obtains essentially the same results, also using the error-correction methodology but limiting his analysis to European countries. Kroner and Lstrapes (1993) impose rationality on perceived exchange-rate volatility and again find a small, statistically
significant impact on their reduced form equation for export volumes. Holly (1995) estimates the structural export supply and demand equations corresponding to Kroner and Lestrade's reduced-form system: He confirms their finding of a small negative effect and shows that it operates mainly by depressing export supply. Frankel and Wei (1993) analyze this relationship using a gravity model framework in which the volume of bilateral trade depends on countries' distance, population, national income and, in addition, the variability of the nominal or real exchange rate. Instrumenting the exchange-rate variability term using the variability of relative national money supplies to control for endogeneity, they too find a statistically significant but economically small impact of exchange-rate variability on trade.  

Thus, recent studies support the hypothesis of a negative relationship between exchange-rate variability and trade while all but universally finding that the posited effect is small.  

Is the exchange-rate variability considered in these analyses plausibly linked to policy? A variety of studies suggest that this is the case. De Grauwe, Janssens and Lelianert (1985) report strong evidence that real exchange-rate variability increases with the variability of inflation and money growth rates. De Grauwe and Rosiers (1984) find that monetary instability is one of the principal determinants of real exchange-rate variability in a cross-section of 39 developed and developing countries. Bayoumi and I (1996) analyze the determinants of real and nominal exchange rates in a sample of industrial countries. We find that the relative rate of growth of money supplies is an important determinant of bilateral exchange-rate variability; country pairs for which the average rate of growth of the money supply differs significantly tend to have more variable (real and nominal) bilateral rates.  

In a study closely related to the issues of concern to this paper, Edwards (1987) analyzes the determinants of both long-run and short-run real exchange-rate variability (the price of tradables relative to nontradables) for a sample of developing countries, finding that real rate variability is caused by both monetary and real disturbances, with real variables (notably the external terms of trade) being relatively important in the explanation of long-run instability (computed on the basis of the coefficient of variation of annual real exchange-rate data) and nominal variables being relatively important for short-run volatility (computed on the basis of the coefficient of variation of quarterly data).  

Edwards' framework provides a logical starting point for analyzing the impact of policy volatility on real exchange rates and on political support for open trade in integrating economies. A logical question to ask is not just how policy variability affects the real exchange rate, as in Edwards' paper, but also how increasing openness alters the link. In an effort to answer it, I updated Edwards' analysis to cover the 1979–93 period. I used annual data; thus, the analysis can be thought of as extending Edwards' analysis of long-run real exchange-rate variability. Using data for all non-oil developing countries for which the relevant variables were available, I re-estimated his basic specification. This relates the coefficient of variation of the real effective exchange rate to the coefficient of variation of the terms of trade, the coefficient of variation of real GDP growth, the coefficient of variation of the rate of money growth, the coefficient of variation of the rate of domestic credit growth, the coefficient of variation of inflation, the average inflation rate and two measures of the volatility of the nominal exchange rate, one based on the effective exchange rate, one based on the bilateral rate vis-à-vis the dollar and finally a measure of openness (the export/GDP ratio). The dependent variable, the price of tradables relative to nontradables, is constructed as a trade-weighted average of the price level in each country's 10 most important trading partners, converted by the period-average exchange rate, relative to the home price level. All variables are expressed in logs, and standard IMF sources are used throughout.

The results of estimating this model are shown in Table 1. While the size and significance of the coefficients differs by specification, the variability of the terms of trade, the variability of the nominal effective exchange rate, and the average level of inflation matter for long-run real exchange-rate variability. This is consistent with the view that economic structure and policy (in particular, the policies affecting inflation and the nominal exchange rate) matter for the volatility of the real exchange rate.

I next addressed the question of whether any of these effects, which presumably work to undermine political support for free trade, grow stronger as integration proceeds. In addition to including the level of openness, as before, I extended the specification by interacting openness with other independent variables; a positive coefficient on
TABLE 1
Determinants of Real Exchange-Rate Variability, 1979–93
(standard errors in parentheses)

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>-3.49</td>
<td>-2.57</td>
<td>-2.78</td>
</tr>
<tr>
<td>(0.72)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Terms of trade variability</td>
<td>0.62</td>
<td>0.40</td>
<td>0.43</td>
</tr>
<tr>
<td>(0.14)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP growth variability</td>
<td>0.34</td>
<td>0.26</td>
<td>0.25</td>
</tr>
<tr>
<td>(0.07)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Money growth variability</td>
<td>-0.14</td>
<td>-0.15</td>
<td>-1</td>
</tr>
<tr>
<td>(0.16)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Credit growth variability</td>
<td>-0.20</td>
<td>-0.11</td>
<td>-0.13</td>
</tr>
<tr>
<td>(0.15)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Inflation variability</td>
<td>-0.28</td>
<td>-</td>
<td>-0.16</td>
</tr>
<tr>
<td>(0.13)</td>
<td></td>
<td>(1.10)</td>
<td></td>
</tr>
<tr>
<td>Bilateral exchange-rate variability</td>
<td>0.01</td>
<td>0.06</td>
<td>0.08</td>
</tr>
<tr>
<td>(0.12)</td>
<td></td>
<td>(0.10)</td>
<td></td>
</tr>
<tr>
<td>Effective exchange-rate variability</td>
<td>0.62</td>
<td>0.77</td>
<td>0.81</td>
</tr>
<tr>
<td>(0.17)</td>
<td></td>
<td>(0.21)</td>
<td></td>
</tr>
<tr>
<td>Average inflation rate</td>
<td>0.52</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>(0.11)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Openness</td>
<td>0.37</td>
<td>0.07</td>
<td>0.02</td>
</tr>
<tr>
<td>(0.21)</td>
<td></td>
<td>(0.27)</td>
<td></td>
</tr>
<tr>
<td>n</td>
<td>30</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>R²</td>
<td>0.81</td>
<td>0.61</td>
<td>0.71</td>
</tr>
<tr>
<td>F</td>
<td>9.57</td>
<td>7.31</td>
<td>7.72</td>
</tr>
</tbody>
</table>

Source: See text.

an interaction term would suggest that the effect in question, linking economic structure or policy instability to real exchange-rate variability, is stronger in more open economies. The baseline model included all of the regressors, as in the first column of Table 1.

The results of these tests for increasing sensitivity of the real exchange rate with growing openness turn out to be mixed. The only variables for which there is evidence of different effects in more open economies are the variability of credit growth and the variability of GDP growth. But in both cases, the interaction terms enter with positive coefficients: that for the variability of credit growth differs from zero at the 95 percent level, while that for GDP growth differs from zero at the 90 percent level. Thus, there is some evidence that the variability of both domestic monetary policy and cyclical instability have a greater impact on the variability of the real exchange rate in more open economies. But this evidence is not overwhelming.

Substantial literature supports the hypothesis that real exchange-rate variability and import penetration are sources of protectionist pressure. For example, Trefler (1993) analyzes the determinants of non-tariff barriers in the United States using industry-level data. He finds significant upward pressure on non-tariff barriers in industries experiencing increases in import penetration. His result is consistent with the notion that policy shifts which give rise to changes in import penetration affect the endogenously determined level of protection. But for policy variability that increased the variability of import penetration ratios to raise the average level of protection, it would be necessary to establish the existence of a ratchet effect (for whether positive changes in import penetration had a larger impact than negative ones or, equivalently, for whether the variability of the import penetration ratio when added also entered with a positive coefficient). This has yet to be done.

Overall Conclusions
The impact on trade of macroeconomic policy generally and macroeconomic policy instability in particular is one of the more contested areas in the literature of international trade and finance. A variety of theoretical models suggest that uncertainty associated with policy instability (and the protectionist pressure it evokes) may prevent the gains from trade from being fully realized, although the work of Helpman and Razin, among others, should remind us that these results require strong assumptions whose generality may be questioned. Recent empirical work also points in this direction: It all but uniformly suggests that policy-induced exchange-rate instability discourages trade, although the magnitude of the effect is small. More needs to be done to establish the channels through which this effect operates, and in particular whether the relative-price uncertainty to which policy uncertainty gives rise is a source of protectionist pressure.

Trade Openness and Macroeconomic Policy
The literature on the implications of openness to trade for the conduct of macroeconomic policy goes back to Machlup (1943), Meade (1951) and Mundell (1963). They suggested that fiscal policy was likely to be less effective for stabilization in more open economies. If it is costly to increase the size of the deficit or to change levels of public spending and taxation, then we should expect to see fiscal policy used less actively in economies where multipliers are smaller due to the existence of larger import leakages. If most of the benefits of a countercyclical fiscal policy leak
abroad in small open economies, then we should expect to see them make less use of automatic stabilizers. Bayoumi and I (1995) provide evidence consistent with this view, showing that individual U.S. states, which are far more open than the country as a whole, do less than a quarter of the automatic stabilization of the federal government.\(^9\)

Working in the other direction is the fact that more open economies tend to have larger public sectors. Rodrik (1996) has documented this regularity, arguing that the public sector plays a risk-reducing role in economies exposed to significant amounts of external risk (terms-of-trade uncertainty, concentration of exports, etc.). Countries in which the public sector makes up a large share of national income may find it relatively easy to effect large changes in tax revenues or government consumption (as percentage of GDP), facilitating the use of automatic stabilizers.

Thus, whether automatic stabilizers are used more or less actively in more open economies is an empirical question. To compare the use of fiscal policies for countercyclical stabilization in more and less open economies, we extended the analysis of Bayoumi and Masson (1995). These authors compare the change in incomes before and after taxes in five European countries: Germany, France, the United Kingdom, the Netherlands and Belgium. Using time series for each country, they regress the change in personal income net of taxes and transfers on a constant and the change in personal income gross of taxes and transfers. (Personal income is expressed in per capita terms, converted into dollars, and normalized by average per capita income for all five countries.) Since fiscal policies are endogenous, the estimates are obtained using instrumental variables (where the instruments include the constant, a time trend and the first lag of the pre-tax and transfer income series). To obtain efficient estimates that take into account the cross-country correlation of error terms, estimates are by three-stage least squares.

To analyze differences in the extent of automatic stabilization in more and less open economies, I re-estimated Bayoumi and Masson's model, adding an interaction term between pretax income and openness (where the latter is defined as exports as a share of GDP). All variables come from the OECD's *Main Economic Indicators*. The data period is 1970–92, and the extended sample includes 16 countries (Austria, Australia, Belgium, Canada, Finland, France, Germany, Greece, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, the United States and the United Kingdom).\(^9\) It is not feasible to follow Bayoumi and Masson's procedure and estimate the 16-equation system using three-stage least squares, since this procedure uses personal income and openness for each of the 16 countries as an instrument, introducing serious degrees-of-freedom and multicollinearity problems. Instead, I estimated the system using a two-step procedure. In the first step I estimated the equation for each country with instrumental variables, using as instruments own-country lagged income, the constant and the time trend. In the second step I substituted the fitted values for the actual values of the independent variables, and re-estimated the resulting set of equations using seemingly unrelated regressions to take into account the cross-country correlation of the error terms.

The result of estimating Bayoumi and Masson's basic specification (with standard errors in parentheses, and where D denotes the first difference) is:

\[
D \text{Post-Fisc Income} = \text{Constant Terms} + 0.900 \times D \text{Pre-Fisc Income}\quad (0.009)
\]

Following Bayoumi and Masson, the coefficients on the slope coefficient is constrained to be equal across countries. (In contrast, the country-specific constant terms, not reported here, are not constrained across equations.) A one dollar change in pre-fisc personal income leads to a 90 cent change in post-tax-and-transfer personal income. This effect is smaller than that obtained by Bayoumi and Masson, reflecting the longer sample period, the larger sample of countries, and the different estimation strategy.

Extending the specification to include the interaction term between pre-fisc income and openness (where openness is measured as the ratio of exports to GDP), one obtains:

\[
D \text{Post-Fisc Income} = \text{Constant Terms} + 0.169 \times D \text{Pre-Fisc Income} + 1.379 \times (D \text{Pre-Fisc Income} \times \text{Openness})\quad (0.022)
\]

The coefficient of 0.169 on \(D \text{Pre-Fisc Income}\) means that a closed economy would offset some 83 percent (1 to 0.169) of cyclical fluctuations in pre-tax personal income using its tax and transfer system. The positive coefficient on the interaction term confirms that more open economies do
less automatic fiscal stabilization. For a country with an export/GDP ratio of 0.5, the slope coefficient is 0.169 + (0.5 * 1.379), or 0.86. Such an economy thus offsets a smaller 14 percent of cyclical fluctuations in pre-tax-and-transfer personal income.

This would appear to be the first systematic confirmation in the literature that open economies do less automatic fiscal stabilization. It is consistent with the notion that because more fiscal impulses leak abroad, they are less inclined to undertake the same costly countercyclical adjustments in government expenditure and taxes as less open economies.

The discussion to this point has focused on fiscal policy; I now turn to monetary policy. Romer (1993) has examined the connections between monetary policy and openness in a framework emphasizing time-consistency problems. Taking the Barro-Gordon model as his point of departure, he posits that the temptation for the central bank to engineer a surprise monetary expansion in an effort to raise output will be less in more open economies. If the first variable to respond to the money surprise is the nominal exchange rate and prices are slower to adjust, as in Dornbusch (1976), then the more open the economy, the greater the welfare loss due to this short-run deterioration in the terms of trade, and the greater the incentive for central bankers to restrain the temptation to unleash a monetary surprise. Romer’s evidence, based on a multivariate regression analysis, is supportive of the hypothesis that policy is less inflationary in more open economies.

This result is consistent with the implications for monetary policy of the literature on optimum currency areas (see, Mundell 1961). More open economies, according to this theory, have a greater incentive to harmonize their monetary policies with those of their trading partners and to stabilize their exchange rates. The more open the economy, the less adequate are the means-of-payment and unit-of-account services provided by the domestic currency, and the greater the incentive to peg the nominal exchange rate in order to import these services from abroad. We should therefore expect to see more open economies make less use of their monetary autonomy for stabilization purposes, other things being equal.

The empirical evidence is consistent with this view. For example, Bayoumi and I (1997), analyzing a sample of industrial countries, find that countries which trade more heavily tend to intervene to stabilize their (nominal and real) exchange rates; this regularity is evident in both the 1970s and 1980s.

Thus, there is some evidence that both fiscal and monetary policies are used less actively in more open economies, as if there exists a higher ratio of costs to benefits of adjusting those instruments. In more open economies, Romer’s results suggest, the relatively active use of monetary policy runs the risk of destabilizing the terms of trade. New results similarly suggest that larger leakages lead more open economies to undertake less automatic fiscal stabilization. If these findings are correct, they suggest that integration has important implications for the conduct of stabilization policies.

**Applicability to Mercosur**

There is considerable evidence that limited macroeconomic policy harmonization, especially between Brazil and Argentina, has created strains within Mercosur. These problems have generally been associated with exchange-rate-based stabilizations, which have created problems of real overvaluation and intense competitive pressure on import-competing producers, on the one hand, and inadequate monetary and fiscal control leading to rapid currency depreciation and real undervaluation, with incidental benefits for exporters, on the other. The consequent political problems have been most severe when policy imbalances affect industries like motor vehicles, which are both politically powerful and seen by the respective governments as integral to their national industrial strategies.

In a sense, these problems can be traced to the fact that effective inflation stabilization in Argentina, which dates to the Convertibility Law of 1991, coincided with the initialing of the Mercosur Agreement during that same year. Given the failure of previous stabilization efforts, even so radical a change in the macroeconomic policy regime as Argentina instituted in 1991 took time to gain credibility. Inflation persisted. Wholesale prices rose by around 6 percent in 1992 and 3 percent in 1993. In Brazil, meanwhile, inflation continued unabated and, typically for a hyperinflating economy, the exchange rate rose even faster than prices (aside from periodic, unsuccessful attempts at stabilization). As early as 1992 this led Argentina to impose anti-dumping measures against Brazilian farm machinery and spark plugs. This was followed by similar measures against steel, refrigerators, paper, agricultural machinery and textiles. By early 1994, policy divergences had created...
serious problems for a variety of Argentine industries. In the first week of January, Argentina introduced protectionist measures against Brazilian chemicals. At a meeting of the Brazilian and Argentine presidents later that month, the latter complained that Argentina had become a "dumping ground" for cheap Brazilian industrial products like textiles, paper and steel.21

Further evidence can be found in the reaction to the stabilization of Brazil's exchange rate in the second half of 1994. Improved policy harmonization allowed Brazilian and Argentine officials to negotiate a bilateral deal for the automotive industry—one of the sensitive sectors granted special treatment under Mercosur—allowing Brazil easier access to the Argentine parts market and eliminating the quotas both countries placed on imports of trucks and vans. By the beginning of the next year Argentine officials could reaffirm their commitment to Mercosur partly because "the partners are now following broadly similar economic policies. Argentina had been fearful that Brazil's undervalued currency (and its overvalued one) would have hit its industry hard. Now Argentines say that the strength of the Brazilian currency...gives them a chance to increase their exports to their neighbors."22

But as with most exchange-rate-based stabilizations, the Brazilian program led to a widening of the trade deficit. The competitiveness and import-penetration problem shifted from Argentina to Brazil. In particular, stabilization led to renewed problems for the Brazilian motor-vehicle industry. While Argentina was still only a minor source of Brazil's motor imports, the two countries were in direct competition for foreign investment by U.S. and European producers—foreign investment that is attracted only to platforms with access to Brazil's large domestic market. Thus a sharp rise in Argentine exports to Brazil, even one starting from a relatively low base, could have major sectoral implications. In early 1995 these considerations led Brazil to double its tariffs on automobiles to 70 percent and simultaneously reimpose quotas, limiting imports to 100,000 units for the second half of 1995.23 Protests by Buenos Aires then led to some improvement in Brazil's treatment of Argentina. When the World Trade Organization condemned the quotas, Brazil removed them but retained the 70 percent import duties, which it committed to phase out by 1999. In January 1996 the two countries reached a bilateral agreement (an exception from Mercosur) allowing producers operating in both countries to bring vehicles from one market to the other subject to zero tariffs, providing that they sent vehicles in the same value in the other direction—hardly meaningful trade liberalization.24

Clearly, this "auto row" was not entirely a product of macroeconomic policy imbalances; the priority the Brazilian government attaches to developing a world-class automotive industry would have fanned conflict with Argentina even in their absence. There is no question, however, that those conflicts were inflamed by macroeconomic problems. This point is reinforced to the extent that conflicts were not limited to the automotive sector. To cite one recent example, in March of this year Brazil, concerned about overvaluation and a growing trade deficit attributable to exchange-rate-based stabilization in conjunction with limited fiscal control, placed restrictions on the financing of imports. This elicited strong criticism from Argentina, which saw these measures prompted by macroeconomic policy imbalances as a threat to Mercosur.25

Thus, the history of Mercosur confirms that poorly coordinated macroeconomic policies can strain a free-trade agreement.26 Repeatedly, exchange-rate-based stabilizations and sharp exchange-rate movements associated with sudden loss of fiscal and monetary control have threatened political support for free trade within the region. The two largest members of the FTA, Brazil and Argentina, have at various times been the source and the subject of these problems. Thus, the corrosive effect of the lack of macroeconomic policy coordination in the Southern Cone can and has cut both ways. And yet even the very pronounced macroeconomic imbalances that have affected trade relations between the Mercosur partners have not permanently disrupted their efforts to deepen and broaden their free-trade agreement.

The Case of the European Union
At this point, many readers will probably conclude that none of the preceding arguments provides a compelling reason why the members of a free-trade area must coordinate their macroeconomic policies. True, when countries follow unstable policies, risk-averse producers may fail to specialize along lines of comparative advantage, and their countries may fail to fully reap potential gains from trade. Consumers and producers discomforted by terms-of-trade fluctuations may lobby for policies that limit the extent to which trade is actually free. But there is little that is con-
tent-specific about these implications: Stable, coordinated policies are always better than unstable, uncoordinated policies. There is nothing fundamentally different in the context of free-trade areas.

Only the history of the European Union (née European Community) is difficult to square with this conclusion. Since the inception of their regional arrangement, EU officials have regarded deepening their customs union and cultivating the close coordination of macroeconomic policies as connected tasks. The Treaty of Rome, the document creating the European Economic Community, identified the exchange rates of the member states as matters of “common interest” (as mentioned in the introduction). The revaluation of the Dutch guilder and German mark in 1961 highlighted the possibility that exchange-rate movements within the Community might create problems for its operation, prompting the creation of the Committee of Central Bank Governors to facilitate the closer coordination of monetary policies. In 1969, its customs union having been completed ahead of schedule, the Community reaffirmed its desire to move to monetary union in order to abolish exchange-rate fluctuations and uncoordinated monetary policies once and for all. Although this initiative led to the formation of the Werner Committee, which reported favorably on the prospects for monetary union and emphasized the need for the close coordination of national fiscal policies, it soon became apparent that the reach of EC officials exceeded their grasp. Still, in response to the collapse of the Bretton Woods System they established the “snake” to limit the fluctuation of their bilateral exchange rates to 4½ percent. The Snake was succeeded in 1979 by the European Monetary System, under which participating countries’ access to credit lines was expanded to facilitate their efforts to hold their currencies within even narrower, 2½ percent bands. Most recently, the members of the European Union, by adopting the Maastricht Treaty, committed to creating a full-fledged monetary union, supplemented by various measures for the supra-national surveillance of national fiscal policies.

Understanding the History

Why this insistence in Europe on marrying a customs union with exchange-rate stability and macroeconomic policy coordination? Part of the answer lies in the perceived threat to free intra-European trade due to the protectionist response of sectoral interests to currency fluctuations (the theoretical possibility discussed in the first section above). Because intra-European trade is so extensive and interest groups are so well-organized, this political threat is especially potent in Europe.

Although examples of its operation can be found throughout the history of the European Community, this dynamic is particularly clear in the response to the pound sterling and Italian lira’s forced departure from the European Monetary System in 1992. The depreciation of these currencies enhanced the international competitive position of Italian and British exporters and intensified the profit squeeze on their competitors elsewhere in the EU. In response, German machine-tool makers complained to their government that their Italian competitors were unfairly underselling them in international markets. The Hoover Company shifted some of its operations from Dijon to Scotland, eliciting complaints from French trade unions. French Prime Minister Alain Juppé warned that France would “react against” EU member states that manipulated their currencies. All this led Mario Monti, the EU’s Commissioner for the Internal Market, to warn that it was “impossible to have a guaranteed single market in a situation where currency fluctuations remained unchecked,” and that “the continuing devaluation of the lira would in the long run lead to prolonged disruption” and pointed to the need for “some sort of monetary arrangement to complement the single market.” 27 A similar conclusion was drawn by the editors of The Economist, who wrote, “as long as Europe’s currencies are free to move against one another, the single market will never be secure. The risk will remain that national governments will seek to protect their countries’ firms against rivals in countries that have just devalued. The greater the volatility, the greater the pressure for national protection and the greater the danger to all the past achievements of the common market.” 28

The susceptibility of Europe’s customs union to exchange-rate-induced protectionist pressures is only part of the story, of course, for the EU is at the same time less than and more than a customs union. It is less than a customs union in the sense that the European Economic Community’s first concrete achievement was the Common Agricultural Policy (CAP), itself a departure from free trade. Deregulating the market in agricultural products was too radical a step for the member states, given the symbolic value of farming and the political leverage of the farmers. The CAP reconciled the customs union with agri-
cultural price supports by establishing minimum domest-
ic-currency prices for a range of farm products. The prob-
lem was that a change in intra-European exchange rates
could unleash a flood of agricultural exports unless support
prices were adjusted whenever exchange rates changed,
something that farmers who valued price stability and pre-
dictability were unwilling to accept. Until the CAP was
reformed in the 1990s in the direction of lump-sum pay-
ments, this departure from free trade did as much to sup-
port the case for intra-European exchange-rate stability as
free-trade initiatives themselves.

If the EU is less than a customs union, it is also more
than one in the sense that trade integration has always been
part of a broader political agenda. The European Commu-
nities were created as a postwar strategy to lock Germany
into Europe. Not only was trade seen as a means of culti-
vating understanding and interdependence between Ger-
many and its neighbors, but commercial integration was
supposed to be a first step toward political
integration.

This commitment to pursue political as well as economic
integration predisposes European policymakers toward initia-
tives designed to broaden cooperation from trade to
exchange rates and macroeconomic policies. It is impos-
sible to understand why some EU member states, Germany
in particular, are prepared to contemplate economic and
monetary union except as part of a broader bargain in
which they sacrifice their monetary autonomy in return for
an expanded foreign-policy role in the context of a more
politically integrated European Union. The Maastricht
Treaty is not just a monetary agreement, after all; it has
three “pillars” concerned with (1) monetary union, (2) a
common foreign policy, and (3) justice and home affairs.

Understanding the Maastricht Treaty

The debate over the Maastricht Treaty underscores this
essential point: In Europe, the Single Market and monetary
union are linked precisely because the EU is more than a
customs union. Indeed, the Single Market itself is more
than a customs union. The Single European Act of 1986
sought to bring down unemployment and banish
“Eurosclerosis” by simplifying regulatory structures, inten-
sifying competition, and helping European producers to
exploit economies of scale and scope. It mandated the elim-
ination of all barriers to the free mobility of labor and cap-
ital. This entailed removing the remaining capital con-
trols. But the elimination of controls liberated speculative
capital flows and rendered it more difficult to hold Euro-
pean currencies within the narrow bands of the European
Monetary System. Given the threat to the Single Market
from currency fluctuations, this pointed to the need for a
single currency to complement the Single Market. This
vision found expression in the Delors Report of 1989 and
the Maastricht Treaty adopted by the European Council in
December 1991.

The other effect of the Single European Act, besides
increasing the difficulty of holding national currencies
within narrow bands, was to magnify the political backlash
against misalignments. The Single Act mandated changes
in non-tariff barriers, public procurement policies, foreign
investment regulation and policies toward distressed
industries, all of which worked to intensify international
competition. By eliminating barriers to intra-EU competi-
tion, these initiatives magnified the shifts in trade, com-
petitiveness and profitability caused by currency swings.
This in turn increased the threat of a protectionist back-
lash. In a sense, then, the Single Act led inevitably to mon-
etary unification by increasing the difficulty of holding
steady the exchange rates between Europe’s separate
national currencies and by magnifying the threat to
Europe’s customs union from the consequent currency
swings.

For readers concerned with Mercosur, it is worth con-
trasting Europe’s Single Market with the North American
Free-Trade Area. There, too, the liberalization of interna-
tional capital flows has increased the difficulty of holding
exchange rate within narrow bands—witness Canada’s
long-standing policy of floating and Mexico’s abandon-
ment, under duress, of its crawling band. There, too, free
trade has magnified the political response to currency
swings, a point evident in the protests heard in Texas and
New Mexico when the peso depreciated in late 1994 and
early 1995. But integration between the three NAFTA
members is not yet so deep that these currency swings pro-
voke protectionist pressures sufficiently intense to disrupt
the operation of the free-trade area.30 While NAFTA con-
tains a variety of side agreements, it does not approach the
deep integration of Europe’s Single Market.

Implications for Mercosur

Four implications for Mercosur follow from our discussion
of the connections between the political economy of FTAs
and the stance of macroeconomic policy.
1) In the short run, the need for macroeconomic policy coordination is limited. So long as Mercosur remains just an FTA and is not accompanied by measures abolishing restrictions on factor flows, subsidies for domestic industry and preferential public procurement like those featured in the Single European Act, the impact of currency swings on the profitability of competing national industries will not be as pronounced as in Europe's Single Market. Hence, exchange-rate-induced lobbying for subsidies and protection will not be as intense.31 There will be less need for the close coordination of monetary and fiscal policies than in the European Union. NAFTA may be a better analogy for the problem that will face Mercosur. While the post-1994 depreciation of the Mexican peso provoked complaints of unfair currency practices from U.S. producers in border states who found their profits squeezed by the decline in Mexico's dollar-denominated labor costs, that pressure was not so intense as to actually lead to the adoption of protectionist measures.

2) In the short run, measures to regulate international capital flows in and out of the Mercosur region will enhance governments' ability to stabilize exchange rates. So long as Mercosur countries can continue to take measures to regulate international capital flows (taxing capital inflows, taxing funds that exit soon after their arrival, raising reserve requirements on banks that borrow offshore), they will retain some capacity to limit the impact on their exchange rates of international capital mobility. They will have more capacity to hold their currencies stable than European governments (which are prohibited from resorting to such devices by the Single European Act). Less monetary and fiscal coordination will be needed to achieve a given degree of exchange-rate stability than if capital markets were totally integrated and open.32

3) In the longer run, the pressure for policy coordination will grow. There are good reasons to anticipate that the integration of Southern Cone financial markets with those of the rest of the world will only intensify over time, with, among other things, the penetration of international banks into the region. If the experience of the European Union is any guide, intra-Mercosur trade will grow disproportionately. But as Latin American financial markets become still more open and competition between the manufacturing and service sectors of the Mercosur economies grows more intense, it will become more difficult to stabilize the currencies of the participating countries against one another, and the potential for a protectionist backlash due to currency fluctuations will mount. This will encourage efforts to coordinate exchange rate and macroeconomic policies among the member states of the FTA.

4) The options for more closely harmonizing the macroeconomic policies of the Mercosur countries are relatively limited. Feasible policy coordination is likely to focus on harmonizing policy rules and guidelines. In principle, feasible strategies (moving from the most ambitious to the least) include a common currency, a common currency board peg, explicit coordination exercises and tacit coordination achieved by harmonizing the rules that guide the formulation of policy. In practice, only the last strategy is likely to be feasible. I consider the alternatives in turn.

a) Monetary Unification. A single currency for the Mercosur countries might seem to be the ultimate implication of this argument. This is unrealistic, however, over any horizon relevant for policy planning. A national currency is an essential concomitant of sovereignty, and nation states are loath to give it up. Besides its symbolic value, the currency is the revenue source of last resort in time of war. Historically, therefore, political unification has always preceded monetary unification. If Europe succeeds in reversing this order, its achievement will be unprecedented. And that achievement will have been possible only because the members of what is now the European Union have capitalized on the powerful impetus for political integration lent by three wars in three generations. They have already spent nearly half a century building transnational institutions of collective governance. Those institutions possess the legitimacy necessary to administer a common monetary policy and the capacity to extend the side payments needed to make it politically acceptable.

Nothing similar is likely to occur for the foreseeable future in South America (or, for that matter, North America or East Asia). Brazil in particular continues to insist that Mercosur should remain a union of nation states and involve a minimum of transnational institution building. Its permanent secretariat is tiny, and decisionmaking power is vested in an inter-governmental Common Market Council comprising the foreign and finance ministers of the member countries. The willingness to hitch unification to economic integration evident in Europe requires a political commitment that is not present in the Southern Cone.

b) A Common Currency Board Peg. Convertibility laws like Argentina's, if adopted simultaneously in all the Merc-
Mercosur countries, are a way of reconciling macroeconomic policy with the need to maintain political support for the FTA. Such laws create political barriers to changing the exchange rate, and if adopted simultaneously in all the major Mercosur countries would prevent currency fluctuations from disrupting political support for the FTA. If each of the Mercosur countries instituted an Argentine-style convertibility law, tying its currency to the dollar, for example, there would be no scope for their currencies to fluctuate against one another and no threat to the FTA from currency volatility.

Currency boards and convertibility laws have costs as well as benefits, of course. They limit policy flexibility and the capacity of the authorities to act as lenders of last resort. These drawbacks may be too high a price to pay for securing an FTA. Even countries like Argentina will ultimately move away from their currency boards as they seek to regain some policy autonomy. Thus, currency boards are unlikely to be a permanent solution.

c) Ongoing coordination exercises. A less ambitious option would be ongoing coordination exercises akin to the annual Group of Seven summits of finance ministers and central bankers and exceptional agreements like the Plaza and Louvre Accords. The Plaza, it is worth recalling, was a response to the soaring external value of the dollar in the first half of the 1980s and to the perception that the difficulties it created for the U.S. Rust Belt would provoke a protectionist reaction in the Congress. It entailed sterilized intervention to bring the currency down. The Louvre Agreement two years later involved more far-reaching adjustments in monetary and fiscal policies, again to prevent exchange-rate fluctuations from eroding support for the global trading system. Subsequent G-7 summits have been designed to construct the policy consensus necessary for more regular coordination of national macroeconomic policies, again with the stability of exchange rates and the trading system in mind.

The problem is that these exercises have hardly been a rousing success. The significance of both the Plaza and Louvre Accords has been questioned (the Plaza because the dollar had begun declining before the agreement, the Louvre because few significant adjustments in macroeconomic policies actually followed). G-7 summits have produced few concrete results, especially in recent years (Bergsten and Henning 1996). It is hard to imagine that a South American counterpart to the G-7 could do better.

d) Common targets for policy. The least ambitious and most realistic option for harmonizing policies is to harmonize the rules guiding their formulation. This could involve the adoption of common inflation targets for monetary policy. This approach is akin to that recommended by the Centre for Economic Policy Research (1996) for the monetary relations between EU countries inside and outside the monetary union. If the European Monetary Union starts without the participation of all 15 EU member states, there will be the problem of preventing currency instability between the "insiders" and "outsiders" from eroding support for the Single Market. Coordinated inflation-targeting by the respective central banks has been proposed as a way of preventing the kind of dramatic misalignments most likely to arouse political opposition to free trade. Experience suggests that considerable short-run exchange-rate variations are still possible between the currencies of central banks following broadly similar policies toward inflation. But the hope is that the currencies of countries adopting common inflation targets would not become seriously and persistently misaligned. The knowledge that their price levels will move together over the long run implies that the exchange rate between their currencies should display long-term stability. And if the policy rule is transparent, stabilizing expectations should prevent serious short-run deviations from that long-run equilibrium. For inflation targeting to have this beneficial effect, however, it must be credible. This requires, among other things, that other policies, especially fiscal policies, do not seriously distort relative prices and create doubts about the stability of the monetary regime. It requires coordination among domestic policymakers, in other words. But it does not also require continuous cooperation with their international counterparts, the obstacles to which are likely to be even more formidable.

Conclusions: Free Trade and Macroeconomic Policy

What does this analysis suggest about whether countries should contemplate an FTA with partners who have not yet adopted sound and stable macroeconomic policies? One answer is that they should pay macroeconomic policies abroad no mind and negotiate an FTA irrespective. This follows from the proposition that divergences between undistorted domestic prices on the one hand and import prices on the other offer the home country gains from trade
whatever the source of the divergence. If import prices decline because policy in the partner country causes its exchange rate to depreciate, that is a source of gains from trade like any other. For the same reason that economists generally oppose the use of anti-dumping duties, arguing that, if a foreign country wants to sell its exports at low prices, that is a source of gains from trade for the importer, they would reject arguments that "exchange dumping" (a decline in import prices due to a policy-induced swing in the exchange rate) is anything other than a welfare benefit.

Another, very different, conclusion is that governments should hesitate to negotiate an FTA until the potential participants have all installed sound and stable macroeconomic policies. Otherwise policy-induced real-exchange-rate-instability will fan protectionist pressures and undermine political support for the agreement. Thus, while a strictly delimited economic analysis points to one answer, a political economy analysis points to another. Which conclusion one then prefers will depend on the force one attaches to the endogenous protection channel.

A final argument derives from the observation that openness heightens the premium on good macroeconomic policy and reinforces the penalty associated with mistakes (International Monetary Fund 1997). An FTA, like other forms of opening, should therefore encourage stabilization and policy reform. In this view, freeing trade should not wait for macroeconomic stabilization: instead it should encourage it.

References


**Notes**

1. While evidence from NAFTA would be revealing, this arrangement is too recent to provide much useful information yet; I therefore concentrate on the EU case. However, the political and economic repercussions of the late-1994 devaluation of the peso are suggestive, and I briefly discuss them below. See also Ruffin (1974) and Turnovsky (1974).

2. See also Ruffin (1974) and Turnovsky (1974).

3. This is true because the relative price of the two goods will not in general equal the slope of the production possibilities frontier. The essential conclusions of this analysis carry over to the Heckscher-Ohlin model, albeit with additional complications. See Batra (1975).

4. This assumption is not unproblematic, as Helpman and Razin (1978) show, but it has the virtue of simplicity. I return to it below.

5. While I relax this assumption momentarily, it is a more plausible starting point than the opposite assumption of risk-averse producers and risk-neutral consumers. Firms are better placed to hedge price risk through recourse to future markets; they have the specialized knowledge needed to transact in those markets and the scale to defray transaction-related fixed costs. They can merge with firms in the sector whose relative price fluctuates inversely with their own or establish a subsidiary there. Households are typically less well-placed to engage in these types of hedging behavior. For all these reasons it makes more sense to treat producers as risk-neutral.

6. Clark (1973) focuses on the relation between exchange-rate uncertainty and the volume of trade in a simple static model, deriving a negative effective of the first variable on the second.

7. These conclusions are strong because the model is simple. If firms in our Ricardian world can reallocate resources after relative prices are revealed, they will be less inclined to insure against price uncertainty by producing a diversified portfolio of products. If they can insure against risk to their profits through recourse to financial markets, their production decisions will be no different from the certainty case. If households can similarly insure against risk to their purchasing power (by, for example, purchasing financial assets whose return is high when terms of trade are poor), their behavior will not differ from the certainty case. Helpman and Razin (1978) provide an extensive analysis showing that uncertainty makes no difference for international trade if producers and consumers can insure against it on financial markets.

8. According to their estimates, eliminating exchange-rate volatility would have increased intra-EC trade, for example, by 0.77 percent in 1980. Doubling that actual level of volatility observed in 1992 inside the ERM would have reduced the trade of the member countries by 0.25 percent.
9. This is also the conclusion of other recent authors; see for example Kumar and Whitt (1992). Gagnon (1989) provides theoretical support for this conclusion; he simulates a theoretical model in which exchange-rate variability has a negative effect on the level of trade, calibrating it to observed trade flows and real exchange rates, which demonstrates that the effect of increasing exchange-rate variability on trade flows is very small.

10. This finding, which comes through robustly for both the 1970s and 1980s, does not carry over to real exchange rates, however. Sapir, Sekkat and Weber (1994) consider also the impact of the level of the exchange rate, as opposed to its variability, interpreting long-standing movements in the level as misalignments. They find that changes in the level significantly affect the volume of exports from the large EU countries to the United States and from the United Kingdom to its EU partners; in contrast, they find no impact on the volume of trade between ERM member countries. This suggests that the relationship between the exchange rate and trade is non-linear: Large exchange-rate changes, like those between the United States, the United Kingdom and the ERM countries, have a significant impact on trade, while relatively small changes, like those that are typically characteristic of the rates linking the currencies participating in the ERM, have no discernible effect. The authors interpret this as evidence that the ERM has helped Europe avoid large, persistent exchange-rate movements capable of significantly dislocating intra-EU trade and provoking serious protectionist pressures.

11. More recently, Rogers and Wang (1995) have reported results consistent with Edwards’ findings; even for a sample of high-inflation countries, they find that real exchange-rate movements depend on both monetary and, somewhat more surprisingly, real (fiscal, as well as other) shocks.

12. These data were available for 30 countries: Bolivia, Burundi, Cameroon, Central African Republic, Chile, Colombia, Costa Rica, Côte d’Ivoire, Cyprus, Dominican Republic, Ecuador, Fiji, Greece, Guyana, Malawi, Malaysia, Morocco, Nicaragua, Nigeria, Paraguay, Philippines, Sierra Leone, South Africa, Togo, Trinidad and Tobago, Uganda, Uruguay, Venezuela, Zaire and Zambia.

13. Following Edwards, wholesale price indexes were used for the partner countries, while the consumer price index was used to proxy the domestic price level.

14. It turns out that the results are insensitive to the exclusion of one of the two nominal exchange-rate variability measures. When these are included as alternatives rather than simultaneously, only the coefficient on the nominal effective rate differs significantly from zero at standard confidence levels. None of the other coefficients is noticeably affected except for that openness, which is significantly greater than zero at the 90 percent level in the equation using the effective rate, suggesting that more open economies have more variable real exchange rates.

15. Readers may be surprised by the negative, insignificant coefficient on the money growth variable. However, this is simply confirmation of Edwards’ results; he too finds that the money-growth variable is insignificant in the long-run real exchange-rate equations, although it tends to matter for short-run real exchange-rate variability (not analyzed here). The negative coefficient results from a few outliers—countries with highly variable rates of money growth but only moderately variable real exchange rates. Omitting the three countries with the most variable money-growth rate causes this variable to switch signs, from negative to positive, though it continues to differ insignificantly from zero at standard confidence levels.

16. These results were sensitive to specification, so too much should probably not be made of them. Dropping other regressors sometimes reduced the coefficients on these two interaction terms below the critical confidence levels. The only other variable that sometimes entered with a statistically significant interaction term in this sensitivity analysis was the average inflation rate. Its coefficient was negative, suggesting that higher average inflation had a smaller impact on real exchange-rate variability in more open economies.

17. His analysis uses data for 1983. He concentrates on non-tariff barriers on the grounds that successive GATT rounds had already reduced the level of tariff barriers to close to zero.

18. Goldstein and Woglom (1991) show that this behavior is plausibly associated with the tendency for the costs of financing deficits to rise with their level.

19. Unfortunately, it does not appear to be possible to estimate the analogous model for emerging markets, given the difficulty of assembling standardized data on the composition of government revenues and expenditure.

20. This hypothesis is true holding constant other determinants of the inflation rate.


23. For a sense of the magnitudes, note that Brazil imported some 200,000 automobiles in the first quarter of 1993.

24. There are other significant departures from free trade as well, although bilateral trade will be duty-free from the beginning of 2000. For details see Sam Laird’s chapter in this volume.


26. Another fact consistent with this conclusion is that, as part of the five-year program agreed to in December 1995 to perfect the free-trade area and customs union, governments committed to moving toward harmonizing their economic policies.

27. The first passage is a direct quote from Monti, while the second and third are the Financial Times’ effort to paraphrase him.


29. It is revealing in this context that the European Communities were designed to encompass not just the economic community but also the Defense Community and the Atomic Energy Community.

30. Recent months have seen a number of calls for Mexico to establish a currency board system under which the peso would be irrevocably tied to the dollar—but not from fear that continued currency swings would undermine political support for the free-trade agreement, but rather in response to doubts that Mexico can efficiently run its own financial affairs on a discretionary basis.

31. All things being equal.
32. This is not to argue that such controls are perfectly effective or even desirable from an efficiency-maximizing standpoint, only that they enhance governments' ability to peg their exchange rates and loosen the link between the exchange rate and monetary policy. See Eichengreen and Wyplosz (1996). On the use of capital controls in developing countries, see World Bank (1997).

33. In addition, there may be circumstances when an exchange-rate adjustment is needed to eliminate a competitive imbalance arising for other reasons—when it is the solution, not the problem. Consider a hypothetical case where Argentina's labor productivity declines exogenously but domestic prices and costs are slow to adjust. If Argentina devalues in response, Brazilian producers will have little reason to complain, since the depreciation of the peso would simply offset the deterioration in Argentina labor productivity. But if the convertibility law prevents Argentina from devaluing, Argentine producers whose profits are squeezed and Argentine workers who suffer unemployment will have an incentive to lobby for hidden and overt import restraints, undermining the operation of the FTA. Rigidly pegging the exchange rate under a currency-board regime may, therefore, prevent the market from venting competitive pressures and only aggravate the protectionist threat.

34. In the absence of an effective enforcement technology, cooperation in the international economic policy domain rests on reputation—on the repeated interaction of the relevant institutional representatives. The G-7 clearly has a leg up on this process and yet has still found it hard to deliver results.

35. The critical qualifier is of course that domestic prices are undistorted; otherwise, we are in a second-best world where trade need not be welfare-enhancing for the home country.
I WOULD LIKE TO THANK PROFESSOR EICHENGREEN FOR HIS PAPER ON "FREE TRADE AND MACRO-ECONOMIC POLICY," WHICH I HAVE READ WITH GREAT INTEREST. THE WORLD HAS BECOME INCREASINGLY INTER-DEPENDENT WITH A RAPID EXPANSION OF TRADE THAT HAS OCCURRED HAND IN HAND WITH THAT OF CAPITAL FLOWS. "GLOBALIZATION" HAS BECOME A COMMON WORD DESCRIBING ECONOMIC ENTERPRISE. OR TO PUT IT DIFFERENTLY, NOT ONLY ARE THE ISSUES ADDRESSED IN THIS PAPER IMPORTANT AT THE MOMENT, I DARE SAY THAT THEY WILL STAY WITH US FOR SOME TIME TO COME.

In structuring my comments, I will first touch upon a number of specific points of the paper, to help set the tone for our discussion, and then I will comment briefly on the role of the International Monetary Fund in the paper's context of macroeconomic policy and policy coordination, and its relationship to trade.

The specific comments:

Professor Eichengreen opens the paper with the assertion that most economists might be tempted to answer "none" if asked what are the connections between trade theory and policy on the one hand, and open economy macroeconomics on the other. This happens notwithstanding the presence of the outspoken student in the back of the class sometimes reminding the instructor that there should be such a connection. In fact, and without trying to be condescending, I wondered whether that outspoken student may have worked in the Fund for a while. One of the workhorses in the Fund's toolbox is the Stand-By Program, and another is its close (but longer term) relative, the Extended Arrangement. These programs are typically called upon initially when macroeconomic policies have become unbalanced, leading to a severe external disequilibrium—i.e., a large shift in the trade and current account position of a country that puts it on a collision course with sustainable growth. Indeed, in the daily practice of the Fund and in our discussions with authorities, one cannot really think of sound trade policies and the opening up of economies to world trade and specialization in the absence of proper macroeconomic conditions. I believe that the assertion by the author refers more to the necessary assumption that has to be made sometimes in the theoretical literature to keep models tractable, rather than to the experience of any minister of finance who needs to balance trade and financial policies on a daily basis, and where a rapid weakening of the trade account requires a swift macroeconomic response to keep the external sector in a sustainable position.

Having said this, in turn the balance between domestic savings and investment that is consistent with a sustainable path of growth, and macro policies could be compatible with different trade regimes. However, in today's globalized world, it will be almost a necessary condition that the trade regime be compatible with a further integration in the world economy to help generate sustained growth for the medium-term.

A second technical detail in the paper that I found interesting was the prominence afforded by the model to

Claudio Loser is Director of the Western Hemisphere Department of the International Monetary Fund.
the idea that consumers, more than producers, might form pressure groups to ask for some domestic production of importables, because of consumer price uncertainty over time. However, in today's world typically one thinks of consumers as comparatively small participants in the political economy of protectionism (I would say that they are the great absentees in the debates), and they might find it difficult to get organized to exercise such pressure. I wonder what the empirical evidence can tell us about the consumer-based protection model. Also, I wonder about the assumption in the consumer-based protection model regarding the ability of a country to affect the relative price of tradables. If countries are by and large price takers, how does the presence or absence of domestic production increase or reduce consumer price uncertainty over time?

I share strongly the idea that access to well-functioning financial (e.g., futures) markets helps reduce price uncertainty over time and thus favors an increase in trade. As you know, the Fund advocates the removal of capital constraints, and we are now involved in a major exercise to bring capital convertibility into the jurisdiction of Fund surveillance. We do this because we believe that, together with stable and transparent macroeconomic policies, such liberalization increases access to funds for investment in a country's area of comparative advantage. Liberal capital flows are also likely to contribute to the better functioning of domestic capital markets by providing access to a wider array of capital market instruments. The benefits of open capital markets thus not only favor trade deepening directly through added investment in output capacities where a country might have a comparative advantage, but also indirectly through improved access to instruments that assist in reducing uncertainty over time and helps in the process of efficient external trade. In this context, I must say that I felt uneasy by the assertion made near the end of the paper that "remaining limits to capital mobility will enhance the government's ability to stabilize exchange rates." Indeed, more often than not, our experience is that the use of capital controls seeks to help stabilize the exchange rate in the response to unstable and unbalanced domestic macroeconomic policies. That is, an endogenous cause of exchange-rate instability, and not some exogenous factor or set of factors that would warrant, at best temporarily, the use of capital constraints. While some countries have made use of these measures, it is my strong belief that beyond the short term, capital controls for inflows become ineffective and that they are absolutely ineffective for capital outflows. In fact, these have harmful effects on confidence and may precipitate the crisis that the authorities attempt to avoid.

Now let me switch to the more general policy issues that Professor Eichengreen addresses in the second part of his paper, namely the applicability of macro coordination to Mercosur. He uses as a parallel example the European Community, exploring the influence that macroeconomic policies may have on exchange and trade relations and the implications from that for the degree of policy coordination that is necessary in regional trading blocks.

The issues discussed here are the regional version of the problems that the Bretton Woods negotiators struggled with when the IMF and World Bank were created. There was broad recognition that a minimum degree of policy coordination and dialogue was indispensable for bringing about acceptable trade relations, and to move away from isolationist competitive devaluations and protectionist trade and capital mobility policies that had proved so damaging to world economic welfare. Not surprisingly then, the first article of the IMF's Articles of Agreement states that one of the purposes of the Fund is "to facilitate the expansion and balanced growth of international trade." In practice we try to meet this challenge through our annual consultations with member countries, which are discussed in the executive board of the Fund in the process of multilateral surveillance. Through this surveillance exercise, the Fund offers a global forum for policy coordination and dialogue. This of course, is reinforced by the work of the third large international agency overlooking international cooperation, the World Trade Organization (WTO), which deals with the agreements to attain a more integrated world of trade of goods and services.

Now, groups of countries may have the opportunity to go beyond this stage of policy coordination by forming an explicit regional trading area. The Fund has been cautiously supportive of such efforts provided that: (1) the regional trading area does not become a regional fortress in which the common external tariff is in excess of the tariffs that were established by the individual member countries prior to the formation of the trading bloc (according to the literature on trade diversion and trade creation); and (2) the policy of opening up trade and payments systems continue not only between member states of the trading area but also for the trading area vis-à-vis the rest of the world. To
do this with any measure of success, I cannot agree more
with Professor Eichengreen’s analysis that over time, the
need for policy coordination will likely grow. That does not
necessarily mean that there is a need to form a single cur-
rency block. While such a notion has clear advantages, it
requires a degree of coordination that in the short run may
entail high costs. The experience of NAFTA shows that
integration can take place if there is a good set of pre-
dictable and appropriate macroeconomic policies, even if
the exchange rate and the pace of inflation differ among
countries. The success with flexible exchange-rate policies
of the United States with its major trading partners,
Canada, Mexico and Japan, testifies to that effect.

In this regard—and again, to paraphrase Professor
Eichengreen—if the policy rules adopted by individual
countries are transparent and lead to increased openness of
trade and payments at very low rates of domestic inflation,
stabilizing expectations that result from this policy stance
should prevent serious short-run deviations in the
exchange-rate equilibrium from that of the long run. This
is even more so the case in the demanding environment of
today’s globalized world. In other words, Professor Eichen-
green indeed hits the nail right on the head when he con-
cludes the paper by saying that there is no substitute for
stable and appropriately cautious macroeconomic policies
whatever the exchange rate and monetary regime. In this
regard, as has always been the case with the outspoken stu-
dent at the back—or front—of the class, his impact
remains significant and helps us see the truth of the state-
ment that good economic policies reinforce each other, but
that one set of bad policies precludes other policies from
succeeding.
XI. Roundtable: Is Protectionism Still Alive?
Is Protectionism Still Alive?

RICHARD BLACKHURST

The question addressed by this panel—Is Protectionism Still Alive?—is, no doubt, a rhetorical one. Protectionism will never die out, certainly not in the lifetime of anyone present at this conference. Like the tide, it is more a matter of ebbs and flows.

My focus is not on specific protectionist threats but rather on what I believe is the greatest current threat to liberal trade policies—namely, the growing backlash against globalization in a number of developed and developing countries. In developed countries, where the backlash is most pronounced, globalization is associated with job insecurity, job losses, declining relative wages for unskilled workers and pressure to reduce social-welfare spending. In developing countries, the concerns vary according to income. The lower-income countries in Africa and the Caribbean worry about being marginalized by globalization. In countries like India, Indonesia and Malaysia, the concern over globalization focuses more on reductions in policy sovereignty—in such areas as the protection of intellectual property and the regulation of foreign direct investment—as the need for multilateral rules becomes increasingly evident.

It is not easy to quantify the extent of the backlash or the threat it poses, but the evidence is mounting. Consider the following: As David Palmeister notes in his paper, U.S. Vice President Al Gore—so effective in debunking Ross Perot’s protectionist arguments—has been conspicuously silent in the face of House Minority Leader Richard Gephardt’s increasingly protectionist rhetoric.

In many Western European countries, where the growing urgency of economic reform to make the economy more flexible is matched by a growing popular resistance to change, a more integrated and competitive global economy is viewed as an unmitigated evil by large segments of the population (witness the recent French and German developments). A variety of well-publicized books and articles have attacked globalization, including James Goldsmith’s The Trap, George Soros’ “The Capitalist Threat” in the Atlantic Monthly (January 1997), and William Greider’s One World, Ready or Not: The Manic Logic of Global Capitalism. And you can add to this William Pfaff, the widely syndicated columnist, who has practically made a second career out of attacking every aspect of globalization.

Then there were the well-organized counter-demonstrations against APEC’s role in promoting globalization at its summit meeting last fall, and the labor unrest in the Republic of Korea at the beginning of the year linked to the demands of globalization (The Economist, January 18, 1997). And not long ago the Chiapas rebels in Mexico devoted an entire evening to burning in effigy not of NAFTA, not of the World Bank or the IMF, but of the World Trade Organization and globalization! (Surely this validates the WTO as a full-fledged Bretton Woods institution.)

Finally, look at Robert Kuttner, commenting in Business Week (April 28, 1997) on a monograph by Dani Rodrik (Has Globalization Gone Too Far?), who provides us with

Richard Blackhurst is with the Graduate Institute of International Studies in Geneva, Switzerland.
this bit of wisdom: “It’s not just that trade dislocates a few losers. Trade undermines the entire domestic mixed economy, by eroding its political and moral foundations.” Thus, a well-known economist teaching at a well-known university has written a monograph that inspires a leading economic journalist to reach such a conclusion, and a leading business magazine to publish it. I think we have a problem.

Contemporary economic literature is very clear on two points. First, liberal trade policies, greater integration into the global market and increased specialization are all key sources of rising per capita incomes. In a world in which large numbers of people go to bed hungry every night, and large numbers of families cannot afford medicine when their children are sick, it borders on criminal to attack economic trends and policy developments that raise standards of living by increasing the efficiency with which the world uses its land, labor and capital.

Second, as the IMF’s latest World Economic Outlook confirms, empirical analysis does not support the claim that trade is a major cause of the downward pressure on unskilled wages in OECD countries or of chronically high unemployment in Western Europe. Technological change, new business strategies and inappropriate domestic policies are all further up the list of factors behind these developments. But many domestic policies are hard to change, and we have not yet reached the point where it is politically acceptable to be against technological progress. So that leaves trade—an important source of income growth and only a minor factor, at most, in the problems it is accused of creating—as the target of choice among those who are fearful of the change that inevitably accompanies progress.

Governments have mostly themselves to blame for the backlash. Their frequent lack of candor regarding the fact that even though globalization clearly benefits the country as a whole, some groups in the economy will lose, leaves the door wide open for critics to jump on this fact as though it were a completely unexpected result that tips the balance against globalization. This is coupled with reluctance to acknowledge that, while globalization creates tremendous opportunities, it also raises the cost of bad policies—such as those that produce labor-market rigidities, over-regulation, substandard schools and educational policies, tax policies that discourage job creation, and chronic budget deficits that reduce investment by reducing national savings. I think we have a problem.

What are the potential costs of this backlash against globalization? If the issue of labor standards can be kept out of the WTO—and since the Singapore Conference the prospects for doing so have improved considerably—then I believe the risk of actually going backward on liberalization is relatively small. Countries are locked into current trade policies covered by their WTO commitments. They could, of course, turn their backs on the WTO, but, barring a very much worse trade policy environment, this is not likely to happen.

The risk, rather, is that the backlash will slow the pace of further multilateral liberalization, or even bring it to a halt. One way in which this could happen would be a shift to a “fortress” approach toward regional integration—for example, in the European Union, with its planned expansion to the east and the immediate south. Yet there is no evidence of this happening. Indeed, the European Union is the leading advocate among the Quad countries of an ambitious new round of multilateral WTO negotiations. A more likely threat is that the backlash against globalization will cause countries to pass up the opportunity to launch a major new round of multilateral trade negotiations in 1999.

Decisions taken at Marrakech require that another round of trade-liberalizing multilateral negotiations, covering agriculture and services, begin before the year 2000. The negotiations could be limited to two compartmentalized negotiations, similar to the ones on basic telecommunications and financial services. An option more in line with what is needed to prepare the WTO for the first part of the 21st century would be to launch a major new round with several items on the agenda. A broad agenda also has the advantage of allowing countries to take politically difficult decisions in certain areas in exchange for progress in other areas that furthers their trading interests. Possible topics for an ambitious agenda that goes beyond agriculture and services include a further round of tariff cuts and bindings on industrial products, state trading, government procurement, competition policies, rules on foreign investment and reform of the rules and procedures governing free trade areas and customs unions.

What would be the cost to the world economy of, say, a five-year delay in launching a new round of negotiations? In terms of forgone growth, it surely would dwarf, for example, the cost of all the anti-dumping actions imposed thus far in the postwar period and in the foreseeable future.
Clearly the WTO, the World Bank and the IMF have major roles to play in combating the backlash against globalization (the Fund's recent *World Economic Outlook* is a good example of what can be done). At the same time, our credibility with the general public on this particular issue must be very low, which means we cannot do it alone. There must be much more active support. National leaders must take seriously their most basic responsibilities of explaining the realities of the modern global economy in ways that ordinary citizens can understand. And the many groups within each economy that benefit from globalization, and whose political support is needed to overcome those prepared to resist all change at any cost, must get off the fence and make their voices and interests heard.
The use of trade-related sanctions in connection with specific labor practices has been and continues to be discussed at World Trade Organization forums, International Labor Organization conferences and in the context of bilateral or multilateral trade agreements.

Where are these discussions leading? The ILO has stated that “liberalization of trade and the realization of the ILO’s objectives are interdependent”—that “lifting restrictions on international trade lays the foundations for social progress, even during the worst years of economic depression.” At the same time, however, the ILO warns us that international competition might be “an obstacle in the way of other nations which desire to improve the conditions in their own countries.” Their solution has been, and continues to be, basic labor standards.

In the wake of widespread trade liberalization and free-trade agreements, we wonder whether the attempt to enforce labor standards is indeed a new form of protectionism. On this question, I have four observations and one rather optimistic note to offer as conclusion.

1. There is nothing new about international labor standards or the attempt to link them with trade.

The original idea of international labor legislation is much older than the ILO. It dates from the beginning of the industrial era, and it grew with expansion of international trade in the beginning of the century. This idea is driven by three goals: (1) the pursuit of social justice; (2) the preservation of peace; and (3) ensuring that competition is not “at workers’ expense.” In practice, these objectives produced a core of seven labor standards—addressed in conventions regarding freedom of association and collective bargaining (Nos. 87 and 98); forced labor (Nos. 29 and 105); non-discrimination (Nos. 100 and 111); and minimum age (No. 138)—plus more than 100 additional conventions on matters of labor contracts (see ILO 1996).

2. The increasingly global economy is characterized by rapid change, social tensions and a generalized perception that international trade is a threat to job holders.

A recent Wall Street Journal/NBC News poll tells us that 43 percent of the U.S. public believes that NAFTA has had a negative impact on America, and only 28 percent believes that there have been benefits. It also tells that 67 percent of the adult population believes that the United States should demand that China improve human rights policies before engaging in free trade. Furthermore, when the Clinton administration asks Congress later this year for legislation putting new trade treaties on a “fast track” to ratification, officials will get in a collision course with labor.

In developing regions, including LAC, we hear concerns over increasing wage disparities and public demands for governments to intervene so that competition is “fair.”

Alejandra Cox Edwards is a Professor of Economics at California State University, Long Beach.
The fact is that political pressures lead governments at least to talk the protectionist talk. Last week, in his first intervention at the National Assembly, the new Prime Minister of France, Mr. Jospin, spoke of his commitment to job creation, and at the same time promised to increase the minimum wage. This is one typical case where those who already earn salaries above the minimum wage are not only not threatened by such a proposal, but may believe that others less fortunate would be helped. Or they may realize that a rising minimum-wage floor puts a limit to competition at the lower end of the wage distribution.

3. Current labor legislation in developing countries contains hundreds of anticompetitive articles.

This protectionism emanates from labor laws that generally grant job security in the formal sector, control unions and establish standardized contracts.

These laws benefit established enterprises, penalize new ventures and encourage informal activities. It is not surprising that protectionist policies with respect to international trade not only coexisted but gained support in the presence of these labor practices. It should also come as no surprise that as trade barriers have come down, the inadequacy of these anticompetitive rules has been revealed.

Chile, for example, experienced high rates of unemployment in the mid- to late-1970s after the trade liberalization. The goods markets were subject to the competitive pressures of international trade, but the labor market was still saddled with anticompetitive regulations and heavy intervention in the wage-determination process. The unemployment problem subsided only after a major labor reform. Argentina, after stabilizing the price level and opening up the economy to international trade, is currently experiencing high rates of unemployment and yet waiting for a labor reform.

In a number of countries, internal and external pressure to improve the labor situation has led to a reexamination of the legislation, but removing competitive barriers in the labor market is politically difficult. In some cases external pressure has helped. Chile, for example, in response to the threat of embargo announced at the ORIT (Inter-American Regional Labor Organization) and encouraged by the AFL-CIO in the late 1970s, revised labor legislation, particularly in the areas of union representation and collective bargaining. The external pressure was aimed at the elimination of a ban on unions, which had been imposed by the military in 1973. The threat of trade sanctions sent the military government to look for technical advice, and it led to new legislation to democratize the labor movement.

The Chilean economy in the late 1970s was already embarked on a process of market reforms, but the reforms had not yet permeated the labor market. International pressure gave economists a window of opportunity to persuade the military that a modern labor law was needed for the sake of Chilean workers. The solution was going to be a major reform, not just a patch-style approach to satisfy the AFL-CIO. By 1980, Chile's labor law allowed full freedom of association, genuine democracy in the conduct of union affairs (election of representatives, affiliation to federations and confederations, setting of dues, individual ballots to decide on strikes), collective bargaining at the enterprise level, strikes exposed to the discipline of the market and without job-security guarantees, and an absence of state intervention in union affairs or collective bargaining (see Pinera 1990). This is an example where international pressure was transformed into an opportunity to improve the competitive stance of an economy, rather than a cause to limit trade.

4. Even in the absence of major labor reforms, the anticompetitive rules encouraged by law are being eroded, because the global economy expands the options of new entrants, increasing their bargaining power.

There are a number of recent episodes in LAC where competitive forces have challenged current labor law. Two examples:

(a) Argentina. In the 1990s Argentina has successfully stabilized and lowered trade barriers. In spite of the significant changes imposed by trade policy and macroeconomic discipline, to this day Argentine law encourages sectoral labor agreements. As mentioned above, there is a major unemployment problem in Argentina. While the existing labor law has not eliminated the operation of market forces, one can argue that the law has slowed down the operation of market forces and favored adjustment through unemployment.

The evidence shows that starting in 1994, salary adjustments began to decentralize to the level of the enterprise, suggesting that the system of industrial labor relations in Argentina is adapting to the new demands of a more competitive economy (see Cox Edwards 1996). The degree to which organized workers can force higher prices onto con-
sumers by taking an inflexible stand in negotiations has been eroded by the availability of production from international suppliers. This availability isolates consumers from the effects of industrial disputes in the domestic economy and forces employers and workers to internalize the costs of their disputes. In short, increased availability of goods from international suppliers forces domestic workers and employers to jointly find ways to increase productivity and take into account the presence of competitors.

(b) Peru. Until 1989 Peruvians were required to make contributions toward retirement and health-care services with the Instituto Peruano de Seguridad Social. The credibility of the Peruvian Social Security fell rapidly in the 1980s, and the number of contributors started to fall—from 18 contributors for each retiree in 1980 to 11 in 1989. This rapid decline was driven in part by changes in the dependency ratio, but more importantly by the added effect of an increase in the use of temporary contracts, which are subject to social security contribution. The increased preference for these contracts revealed that employers and workers saw the social security system as a pure tax. Workers, in agreement with employers, preferred to use the 9 percent payroll equivalent to buy health insurance in private institutions—the so-called Family Clinics.

Let me give you two other examples where the inadequacy of these anticompetitive rules has been revealed and challenged from outside of the domestic economy—and in the name of “fair” trade:

(a) The NAALC (North American Agreement on Labor Cooperation), or NAFTA Labor Side-Agreement, promotes compliance with, and effective enforcement of Canadian, U.S. and Mexican labor law, fostering transparency in the administration of labor law. The agreement was signed in September 1993. The main objective of the agreement was to improve workers’ conditions as NAFTA promotes more trade among the countries. It has required the establishment of national offices in the three countries, which have provided an instance where the specific applications of each country’s labor legislation can be challenged. So far, seven submissions have been filed with the U.S. office and one with the Mexican office. Four of the submissions challenge, in one way or another, the right of official Mexican unions to represent workers in collective bargaining.

The corresponding review process has revealed the lack of practical knowledge in each of the three countries about the application of legislation on the right to organize and represent workers in collective bargaining. This is being followed by cooperative studies and better understanding of each country’s practices. This implies that the side agreement helps new entrants and weakens the entrenched positions of anticompetitive forces.

(b) The revision of Convention No. 96 on fee-charging employment agencies was one of the activities during the June ILO Conference in Geneva. Convention No. 96 was adopted in 1949, when nearly all employment agencies were public entities, and it fails to recognize the role of private employment agencies. A new ILO standard fully recognizing private employment agencies as actors on the labor market, has important implications for the legal approach to labor contracting in agriculture and construction, and for the growing phenomenon of international labor movements.

Conclusion

All of this leads me to conclude the following: Protectionist forces are unlikely to disappear, and their voices are likely to get louder with the competitive challenge of the global economy. At the same time I believe that the support for free trade is significant among new players in the international markets. The balance between these...
two forces can be tipped in one direction or another by government intervention that responds to public opinion. Therefore, as social scientists, we have a serious responsibility in front of us in terms of persuading the public and government officials of the beneficial effects of trade and the synergy that exists between increased trade, economic growth, improvement in labor conditions, poverty alleviation and enhancement of democratic systems.

At the same time, for trade to be freer and its effects to spread out, there has to be free entry, particularly to the labor market. This is not going to happen automatically in Latin American countries, because there are a number of legal constraints that have to be recognized and removed.

Finally, I believe that labor reforms in LAC would be more appreciated and understood if presented as efforts to validate what is already happening and as efforts to remove anticompetitive barriers.

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Is Protectionism Still Alive?

DAVID PALMETER

The question for this panel is, "Is protectionism still alive?"

I am able to respond to this question only from the perspective of the United States. From that perspective, protectionism is very much alive. Not only has protectionism in the United States not died, a good case can be made that it has never been seriously ill. Even near the height of post-war U.S. internationalism, U.S. protectionism was strong enough to prevent approval of the International Trade Organization, and shortly thereafter, it was strong enough to seek and obtain a GATT waiver for U.S. agricultural subsidies. And those, from the liberal trade perspective, were the good old days.

It is interesting to look back 50 years from this summer of 1997. In 1947, a Democratic President—Harry Truman—faced Republican majorities in both the House and the Senate. But politics, it was said then, stopped at the water's edge, and Truman was able to accomplish much: 1947 was the year of GATT, of the Marshall Plan and of the Truman Doctrine, which committed the United States to the defense of Greece and Turkey and other nations resisting Soviet expansion. It probably was the high water mark of U.S. internationalism. Rejection of the ITO and the agricultural waiver followed in a few short years.

Today a Democratic President again faces Republican majorities in both the House and the Senate, but the situation is very different. So far, President Clinton has been unable even to get fast-track trade negotiating authority approved by Congress, and his problem is more with his own party than with the Republicans.

The Democratic leader in the House of Representatives, Richard Gephardt, has made trade a major issue. To be sure, Mr. Gephardt would deny that he is a protectionist. He would describe himself as a "fair trader." "Fair trade," in Mr. Gephardt's view, is trade in which all nations have the same labor and environmental laws and pay the same wages for the same work. They also have neutral balances of trade with each other. But if you would refuse to liberalize trade until those conditions prevail, you would refuse to liberalize trade forever. Some are unenlightened enough to call that "protectionist."

Mr. Gephardt speaks for the "liberal" wing of the Democratic Party. (In U.S. usage, "liberal" means the opposite of what it means in most other countries; it is close to the term "social democrat." "Libertarian" is the term we in the United States use for those called "liberals" elsewhere.) The liberal wing of the Democratic Party is fueled by labor and environmental activists. They are the ones who contribute the money, put up the posters, ring the door bells, stuff the envelopes and participate fully in the nominating process. Thus, they have a disproportionate impact in Democratic Party politics, and they are not in favor of liberalized trade.

David Palmeter was a trade lawyer with Powell, Goldstein, Frazer & Murphy, LLP, in Washington, D.C. He currently is a Partner in the International Practice Group in Washington.
This clearly worries Vice President Al Gore, who expects to be challenged for the Democratic presidential nomination by Mr. Gephardt in 2000. Mr. Gore, the champion of the high-tech world of tomorrow and the vanquisher of NAFTA opponent Ross Perot in a widely viewed television debate, is cooling his free-trade rhetoric. He obviously is concerned that the Democratic protectionists could deny him the party's nomination.

That very term—"Democratic protectionists"—is something new in the politics of the United States. The Democratic Party traditionally has been the free-trade party. From Thomas Jefferson and Andrew Jackson to Woodrow Wilson to Franklin Roosevelt and Harry Truman, Democrats have been the champions of freer trade. As for John Kennedy, Joseph Kraft, an influential columnist of the time, called the 1962 Trade Expansion Act "the unifying intellectual principle of the New Frontier." 1

Historically, the Republicans have been the protectionists in the United States. They were the high-tariff party: Smoot and Hawley, the authors of the infamous Tariff Act of 1930, the highest tariff in U.S. history, were Republicans, part of a tradition that included William McKinley, Calvin Coolidge and Herbert Hoover. This is a very strange cast of intellectual forebears for a Democratic leader of the House of Representatives, but Richard Gephardt's trade policy has more in common with them than it has with Democratic presidents from Jefferson to Kennedy to Clinton.

Presently, the intellectual leadership of the free-trade movement in the United States is in the libertarian, free-market wing of the Republican Party, but the free traders are losing ground to the traditionalist "Main Street" Republicans, and to the "social" right that sees freer trade as inimical to moral values such as social stability.

The protectionist opponents of freer trade are exploiting these many non-economic concerns, from the environment to human rights. Aiding them in this exploitation is the intuitive appeal of protectionism, an appeal that is, for most followers of trade issues, amazingly—if wrongly—strong.

The intuitive appeal of protectionism is combined with the view that trade is a weapon to be used in a larger struggle. "Our market" is seen as something valuable, which we make available to others for the primary, if not exclusive, benefit of those others. Those others want to sell; we don't particularly want to buy. We buy, in this view, only to reward other countries for their implementation of policies of which we approve.

Underlying both this assumption and the intuitive appeal of protectionism is the widely held idea that imports are the price a nation pays in order to export. Imports are bad; exports are good. To economists of just about any persuasion this is an absurd statement, but few can deny that outside the economics profession it is widely held, and not just by the uneducated. Read the journalists and listen to the radio and television news reporters and commentators. Apart from a few whose work appears on the business pages or on the economics programs, journalists seem never to have heard of the doctrine of comparative advantage.

Even reporters who specialize in trade coverage sometimes stumble. Consider a recent report by Nancy Dunne and Daniel Dombey in the Financial Times. They report that in 1993, General Motors sold 10 U.S.-made vehicles in Mexico, while last year it sold 31,000. NAFTA, they suggest, has been good for GM. "But whether it is also good for America is another matter," they write. "NAFTA's opponents would point out that last year GM exported nearly seven times as many vehicles from Mexico to the U.S. as went the other way." 2

These experienced writers on economic and trade issues question whether one company's imports of a single product from a single country are "good for America"—if the imports are seven times greater than the company's exports of that product to that country. The clear implication is that this is not "good for America." The reporters assume the validity of the Gephardt view that unbalanced bilateral, sectoral trade is bad. They don't explain why. (I might point out that I have an unfavorable bilateral balance of trade with the Financial Times. I've been buying it for years, and they have yet to send any legal business my way.)

There is a clear need to educate the public—and the journalists—in the fundamental teachings of economics. After all, in democracies, economic policy, including trade policy, ultimately is decided by the voters. If voters are ignorant and ill-informed, how can trade policy be otherwise? Who will do the informing? Surely the work must begin with the economics profession, but this raises a further problem: Economists apparently are not particularly enthusiastic about teaching the public the basics.

To a non-economist the economics profession seems to have a very odd bias against those in its ranks who speak to the public in understandable prose at the level of the basics. It isn't so much that this activity does not merit the acco-
lades that accompany original research of the kind that might lead to a Nobel Prize. It is that such activity actually seems to detract from an economist’s professional reputation.

Paul Samuelson, in the introduction to a recent edition of his textbook, gives an example of what I mean. He wrote:

Back in those days, a promising scholar was not supposed to write textbooks—certainly not basic texts for beginning sophomores and freshmen. Only hacks were supposed to do that. But because I had already published so many research articles, it seemed that my reputation and prospects for lifetime tenure could afford me the elbow room to respond positively to MIT’s request for a new textbook.³

In other words, with the work that would secure his Nobel Prize behind him, Samuelson believed his professional reputation could sustain the inevitable hit that would follow from writing for the uninitiated. And this would follow, it should be noted, from writing for university students. Never mind that economic literacy also is needed for those who do not study at universities.

When basic trade economics are explained to the public, the results can be salutary. A couple of years ago, during Peter Sutherland’s tenure as the last Director-General of GATT, the Economics Division—then under the direction of Richard Blackhurst—issued a report on the impact of trade restraints on consumers. In rather striking language for a document produced by international civil servants, the report explained such things as “how governments buy votes on trade with the consumer’s money.”

Nothing in the report was pathbreaking; nothing surprised any economist or trade-policy official. Yet the public—at least as reflected by the journalistic response to the report—was astounded. Front-page articles and leading segments on the nightly news informed the public that they were paying significantly higher prices because of tariffs and quotas. Many reporters honestly were amazed to learn that governments bought votes with the consumer’s money. So far as I know, the Secretariat’s report on the cost of trade to consumers has not been repeated. This is regrettable.

The WTO should serve as an educational force for the ideas on which it is grounded. It should miss no opportunity to explain them to a skeptical world. An excellent opportunity to do this occurs with the Trade Policy Reviews (TPR) now regularly conducted for each WTO member. In addition to the discussion of a member’s trade policies, a section of every TPR report could deal with the cost to consumers of those policies. It could compare and contrast what consumers in other countries are paying for the same article. And it could be released by a savvy media office that wrote effective press releases and distributed them to the media outlets that would do the most good.

This might not kill protectionism off completely, but it would be a good start. We need a vaccine for the protectionist virus, and the best candidate is likely to be Jagdish Bhagwati’s “Dracula Effect.” “Exposing evil to sunlight,” he writes, “helps to destroy it.” ⁴ In fact, this is probably the only legitimate, and effective, long-term vaccine in a democracy.

This means more than economists writing for each other or even for the readers of newspaper business sections. It means teaching the lay public. In this world of increasing democracy, teaching the public increasingly amounts to teaching the heads of government, for in democracies that’s who the real heads of government are. Teaching heads of government is an honorable calling, certainly not one to be scorned.

The founders of GATT, some 50 years ago, were not motivated by a search for economic prosperity for its own sake, as beneficial as that is. The founders of GATT were too well aware of what happens in a world of economic turmoil and misery, which protectionism exacerbates. They knew from first-hand experience that what Peter Sutherland said half a century later was all too true: “When countries stop trading goods, they start trading blows.” ⁵

The economists who succeed in teaching the world’s lay public the benefits of free trade and the costs of protectionism are unlikely to be nominated by their colleagues for the Nobel Prize in economics. The prize, quite reasonably, is not for that kind of work. The Nobel Prize for peace is not for that kind of work, either. But perhaps it should be.

Notes
1. As reported in Arthur Schlesinger, A Thousand Days (1965).
Is Protectionism Still Alive?

T. N. SRINIVASAN

Protectionism is not only alive, but is also well and, indeed, thriving. I asked a distinguished economic historian, Barry Eichengreen, who is with us here, when protectionism was ever absent. He told me that in the heyday of the gold standard in the late 19th century, not only was there much less protectionism, but the world was perhaps globally integrated as much as it is now. The shares of foreign trade and foreign capital flows in GDP were as high then. In addition, there were virtually no barriers to the migration of workers and their families between countries. Global integration in the last decade of the 20th century is in many ways a return, except for the important exception of free migration, to a situation that prevailed a century ago. I do not wish to exaggerate these facts, but only to put the present trends into a historical perspective without denying that contemporary global integration is different in many respects from that of the past.

Protectionism is no longer, to use an American phrase, of the plain vanilla variety of tariffs and quotas. In the post-Uruguay Round (UR) world, protectionism comes in fancier varieties, such as labor and environmental standards, safeguard and anti-dumping measures, regionalism, and so on. This is not to say that old-fashioned protectionism no longer exists.

Indeed, in spite of the liberalization agreed upon at the UR, agricultural products will continue to be protected through tariffs and quotas for a long time to come. As is well known, the agricultural tariffication process initiated by the UR agreement was used by the contracting parties of the World Trade Organization (WTO) to bind tariffs at levels far higher than applied tariffs. The tariff reductions of the UR agreement thus start from high base levels. As such, not much liberalization of agricultural trade was achieved in the UR. The infamous Common Agricultural Policy of the European Union (EU) has not been dismantled either, though its choice of policy instruments can no longer be as blatantly protectionist and distorting of world agricultural markets as before.

The UR Agreement on Textiles and Clothing (ATC) envisions the phaseout in 10 years of the notorious Multi-fibre Arrangement (MFA). Under MFA, export quotas were bilaterally negotiated by the exporter and its importers, and administered by the exporter. In this phaseout, much of the liberalization is to be achieved in the final years. In fact, products accounting for almost half of the value of 1990 imports could still be under quota restrictions as of the last year of the phaseout. I should hasten to add, however, that the agreed upon increases in the rate of growth of quotas could mitigate their effects. Nonetheless, given the importance of the textiles and apparel industry in the United States and the European Union, I fear that the forces opposed to the abolition of MFA could gather sufficient strength to prevent it from happening altogether. There are already some straws in the wind in this regard.

T. N. Srinivasan is Director of the Economic Growth Center at Yale University.
First of all, as many developing countries complained at the Singapore Ministerial meeting of the WTO in December 1996, the industrialized countries have apparently not been living up to the spirit, if not the terms, of the ATC. The industrialized countries strongly deny that this is the case. Second, WTO-sanctioned safeguard measures have already been invoked against apparel imports. For example, the United States imposed restrictions in April 1995 on imports from India of women’s and girls’ wool coats and woven shirts. India complained about this to the Textile Monitoring Body (TMB). The TMB concluded that, with regard to wool coats, serious damage from imports had not been demonstrated, while in the case of woven shirts and blouses, a demonstrable threat of serious damage existed. In October 1995, India requested the TMB to review the two cases again, but the TMB reaffirmed its earlier decisions. At India’s request, a panel was established in April 1996 to report on the case. Soon after the establishment of the panel, the measures against coats were withdrawn by the United States. In the other case, the panel held that the United States violated the ATC. While it is comforting that the Dispute Settlement System of the WTO seems to be working in this and other disputes, the fact that disputed safeguard measures were invoked is in itself a matter of concern. Besides, if the country on whose exports safeguard measures are invoked is a developing country, and the one invoking the export measures is an industrial country, the cost for the developing country to hire lawyers and go through the WTO dispute settlement procedures is very high. Thus, invoking safeguards has a clear protectionist consequence, intended or not.

Third, there is the case of provisional anti-dumping duties for a six-month period imposed by the European Commission (EC) against grey cotton imports from several developing countries. This is a situation in which exporting countries were already at the limit set by MFA, so that even if they were dumping, they could not raise the volume of exports and possibly damage the textile industry in the EU. The dumping margins were based on price comparisons through a price averaging methodology that recalls the worst of what used to be the case prior to the UR agreement, and which was supposedly ruled out by the UR. Although the EU trade ministers refused to back the duties at the end of the six-month period, the EC has opened yet another dumping investigation in response to a renewed complaint by the cotton producers’ lobby, Euro-cotton.

Turning now to labor standards, an attempt was made at the last minute prior to the signing of the Final Act of UR to include a so-called “social clause” in the mandate of the WTO. Fortunately, it did not succeed. Subsequently, at WTO’s Singapore Ministerial, it was decided to leave the matters relating to labor standards to the ILO. Unfortunately, the misguided, if not muddleheaded, Director-General of the ILO has made proposals that in effect would bring about a linkage between market access and enforcement of a so-called “core” set of labor standards, a linkage that was explicitly ruled out in the WTO. Although the cost advantage gained through the flouting of universally agreed upon labor standards, and trade based on such advantages, should be deemed illegitimate, it is not the case that the so-called “core” labor standards being pushed by the United States and other developed countries can be claimed to be universal and eternal. Indeed, they cover only those standards that are most likely to be lower in developing countries and not other standards that have equal legitimacy, but that are not prevalent in many developed countries! In any case, most governments of the world, with the notable exception of the United States, have signed conventions that promise a much more comprehensive set of human rights, including labor standards, than the so-called “core.” The emphasis on a subset of standards that are presumably lower in developing countries, the asymmetry in excluding others not present in many developed countries and, above all, the fact that the “core” standards are being pushed at a time when there is a perception, if not a reality, in industrial countries that import competition with labor-abundant developing counties is the cause of the stagnation of real wages of unskilled labor—all suggest that protectionism is the driving force behind the push for labor standards.

The issue of trade and the environment is already on the WTO’s agenda. Here again, protectionism could emerge under the cover of a concern for the global environment. Let me conclude with a few remarks on regionalism. As I mentioned in our inaugural session, open regionalism is an oxymoron—either a regional trade agreement is preferential to members and, hence, discriminatory toward non-members, or it is open and non-discriminatory toward all countries on a most-favored-nation basis, in which case its regionalism has no meaning. There is no way regional preferences in such agreements can be legitimized by attaching the words “free trade” and “open.” The trade-diversionary,
and hence, protectionist, implications of regional preferences are clear. What is more, if some of the protectionist leaders of the U.S. Congress, such as Representative Richard Gephardt (D-Missouri), have their way, clauses on labor and environmental standards will become an essential part of any future trade agreement of which the United States is to be a member. This does not bode well for the future of a liberal world trade order.
XII. Roundtable: The Future of Regional Integration
LET ME TOUCH ON FOUR THEMES: FIRST, THE CONFERENCE MESSAGE; SECOND, U.S. TRADE policy; third, issue-linkages; and then, specifically, the future modalities and timing of hemispheric trade negotiations.

So, first, with regard to the message of the conference, I would note that in the very title of the conference sponsored by the World Bank—"Trade: Towards Open Regionalism"—there is no question mark after that title. What I think is most significant about this meeting is that, in effect, we are witnessing here a positive engagement by the World Bank on behalf of Western Hemisphere trade integration.

This conference included a number of the speakers from the World Bank. Although they say they are speaking for themselves and not the institution, the overall clear message nevertheless has been that there are potentially important gains from hemispheric trade integration.

One can debate the static gains, but even if one concedes that point to Jagdish Bhagwati, conference participants have placed a strong emphasis on the dynamic gains from trade integration: economies of scale, investment, technology transfer, learning-by-doing, information, the themes developed by Joe Stiglitz. Some of these dynamic gains from trade were overlooked by Vinod Thomas, if I remember him correctly.

Speeches have also pointed out the political returns from trade integration: reciprocal lock-in, alliances created among pro-reform factions, pro-integration movements across countries, civil society integration, more-likely peaceful settlements to disputes, and general advancement of harmony in the Western Hemisphere through atmospherics, through positive incentive structures, through cross-country coalitions. These positive linkages can be largely implicit and without overly burdensome incentives, conditions which, by the way, meet Professor Bhagwati's third exception that allows him to favor regional trading arrangements. Moreover, one basic message is that regional integration under these conditions should be consistent with eventual movement toward WTO, freer trade, and convergence toward global trade integration. The basic message of this conference is positive engagement by the World Bank toward Western Hemisphere free trade.

Now, what was not discussed here? We talked about open regionalism, but we never talked about the possibility of extra-hemispheric membership, which is to say we did not really talk about fully open regionalism, if by open one means open to all possible countries that might be interested in membership if they met certain technical conditions. Instead, our discussion here of open regionalism has been geographically circumscribed, not a fully open regionalism.

We could get away with this, I think, because when hemispheric integration first became topical, many Asians and Europeans were nervous that they might be somehow
excluded from a dynamic trading bloc in the Western Hemisphere. In fact, they found, as some of the slides displayed here showed, that their firms can, through direct investment, jump into the Western Hemisphere market and profit by it. Hence, you hear less noise and less concern now in Europe and Asia about Western Hemispheric trade integration.

Now let me turn to U.S. trade policy. Yesterday, there was a lot of talk about fears of protectionism in the United States. Of course, there are protectionist forces there, but, frankly, I think they were overstated here yesterday. Public opinion polls show that opinion on trade is soft; it all depends on how you ask the question. On China, for example, if you ask people whether we should maintain preferential trade arrangements with blood-thirsty Communists that use slave labor and exploit children, you can predict the answer. Similarly, if you ask people whether we should trade with China in order to offer more choice to American consumers and to maintain U.S. influence in Asia, you can also predict what the response would be in that public opinion poll.

Opinion is very soft. Also, there is a big difference between political influence and general public opinion. In the United States more than 40 percent of the population does not vote even in presidential elections, and when it comes to influencing political parties in Congress, the wealth effect is certainly relevant, as is the education effect. Hence, the protectionist forces often tend to make more noise but in the end exert less influence on the political process.

The Clinton administration has a clear strategy on getting fast-track authority from Congress. The White House decided at the beginning of this year that first they would deal with China MFN, then this summer they would deal with budget issues, fiscal issues, and then in September, in the fall, they would tackle fast track. It is a debatable but clear congressional strategy. That has left the impression that the administration does not care, but that is a mistaken impression. It is just a congressional strategy.

If you look at what happened on China MFN, I think there is reason to be heartened. The administration looked as if it was being slaughtered. House Minority Leader Richard Gephardt and others were out there, but the administration waited, according to its strategy, so that they would peak at the time of the congressional vote. In order to do that, you begin the campaign several weeks before the vote. You make sure everybody in the Cabinet and who deals with the press has a single message, which they did, and then you go out and you sell it and you peak and you win, and the administration won in Congress in both political parties with a comfortable margin. I think that should hearten us.

It was interesting in the China debate. There were several major issues that the administration put forward, and these are relevant because I think you will see similar issues in the fast-track debate. First, the administration put forth some commercial arguments, but in the end, commercial arguments would not carry the day. They raised it to a presidential issue, to a strategic political issue—more precisely, the matter of strategic engagement with China and Asia more generally.

In addition, the administration met the arguments of the opposition, which is to say they had to say something about, in this case, human rights issues. The administration said, in general terms, structurally speaking, freer trade is likely to produce more political freedom, but, also, we do have some short-term policies that we will try to use to improve human rights in China—not linked, however, to MFN.

There are two worrisome concerns, though, with respect to the political situation on fast track in the United States. Gephardt, I think, has very successfully recognized the mistakes that had been made by Ross Perot and Pat Buchanan during the NAFTA debate. He avoids a racist undertone that can cause him to be easily dismissed. He wraps himself in high moralism, high principle, democracy, human rights and an assertive but positive nationalism. So Gephardt's arguments are dangerous. The other issue of concern is whether or not U.S. business will really engage in the fast-track debate.

South America, which is what is at stake essentially, is interesting to U.S. business. You can put some projections about future Mercosur growth, such that it looks like a somewhat interesting market. However, given the unilateral liberalization that has already occurred in South America, the additional gains through an FTAA (Free-Trade Area of the Americas) for U.S. commercial interests are interesting, but not overwhelming in dollar terms. So we do not yet know how much of an effort the private sector will make.

Nevertheless, if I look at the balance, and what I think is the administration's commitment, despite the ominous
problems, I say it is more likely than not that the administration will get fast track before Santiago. We shall see.

Now, let me talk about the politics, as I see it, of free trade in the Western Hemisphere. Of course, all of these free-trade agreements have had a fundamental political drive behind them. The European Common Market, the European Union, was all about overcoming historical hostilities between France and Germany, and, similarly, as the EU expands now eastward, that is also precisely about overcoming the historical tendencies toward instability and authoritarianism in Eastern Europe.

When President Enrique Iglesias talked about Mercosur, he underscored the political impetus behind Mercosur. And today my good friend from Itamaraty also clearly pointed out there is a geopolitical project involved in Mercosur.

Which countries does the United States have FTAs with? Israel, Canada, Mexico. Obviously, strategic issues are at stake.

How did we even get to a Free-Trade Area of the Americas when, in fact, if you looked at the politics, the United States government was not particularly enthusiastic, the Brazilian government was not particularly enthusiastic in 1994, the Mexicans have no reason objectively to favor further opening up—reducing their preferential margin of access to the U.S. market and letting the South Americans in? (Objectively, the Mexicans have no reason to support it, although, diplomatically, they have to.) So, in fact, there was not a lot of support for the FTAA through 1994.

Why did it happen? It happened because of the Miami Summit. At the Miami Summit—and this, I might add, is documented in my current book, *Summitry in the Americas*—the other Latin American countries led at that time by Argentina (none of those major countries I’ve already mentioned) defined the success of the Miami Summit in terms of agreement on an FTAA. Because both Brazil and the United States felt that the Miami meeting had to be defined as a success, they had to sign on, and it was the summit process and pressure from the majority of Latin American countries—not the United States—that put us on the road toward a Free-Trade Area of the Americas.

Santiago can play a similar role in driving decision-making, both in Brasilia and in Washington, D.C., toward further progress. The progress on the FTAA, though, has to be wrapped, again, in a broader political agenda in order for it to succeed both in Brazil and in the United States. Moreover, the summit process offers a positive opportunity to hammer together a broad package of measures that benefit most of the people in the Western Hemisphere. This could be done, as I think Aleksandra Cox Edwards and others at this conference have pointed out, by and large without sanctions, recognizing essentially national laws, but trying to press for them to be implemented with greater efficiency and vigor.

Miami implicitly tied democracy—the necessary precondition for this process of hemispheric integration or cooperation—to free trade, but it did not make the linkage explicit. Mercosur has explicitly linked democracy and free trade, a linkage that was manifested in April 1996 in the Paraguay incidents. Recently Mexico, in opening up its negotiations with the European Union on trade, has agreed to tie trade to human rights. Hence, it seems to me everybody is now on board that there should be a relationship between—an explicit relationship between—trade and respect for democracy and human rights. I would advocate that in Santiago the linkage be made explicit, which is to say no country that is not a democracy participates in free-trade agreements in the Western Hemisphere. The purpose there, of course, is to create a deterrent to make sure that democracy stays on track throughout the hemisphere.

There are some other issues I think could and should be dealt with in the summit process, issues that bolster political support and political sustainability for free trade. Those issues include governance themes, reducing corruption, combating narcotics trafficking, and, very importantly in terms of convincing people that they have a stake in the liberalization process—and Vinod Thomas emphasized these matters—the importance of education and poverty alleviation. Inequality, as we appreciate, is the weak point in the globalization process altogether. And the Chileans have said they want to make social issues and poverty alleviation the centerpiece at the Santiago summit. My suggestion is that well before we get to Santiago, the World Bank and the IDB should be sitting down with the Chileans and others and building a serious education initiative that would close the gap between East Asia and Latin America and put funds and real money and resources and technical assistance behind the initiative.

The last of the main points I want to address here are negotiations, modalities and timetables of the trade talks. We have focused here, actually, more on Mercosur. Being in South America, that makes sense, and Mercosur is the most dynamic, hot topic. But in fact, NAFTA is, depend-
ing upon how you measure it, seven to ten times, the size of Mercosur. Originally, as we thought about Western Hemispheric trade integration, we saw NAFTA as the magnet, but the United States, because of domestic political reasons, has left a vacuum the last two or three years, and Brazil very astutely has moved in to fill that diplomatic vacuum.

Personally, I am all in favor of Mercosur. I think it is terrific in terms of overcoming historical hostilities and problems in South America. It also clearly can be an important building block from an economic and trade point of view for Western Hemispheric free trade, but I think Mercosur does entail two risks.

One is this talk about how we have to “consolidate” Mercosur before we can really, seriously move forward towards a hemispheric trade initiative. What exactly is being consolidated? If we are consolidating efficient firms capable of moving forward and competing in a global marketplace in a fairly short period of time, okay. But if what we are consolidating, in fact, are protected inefficient firms, then I would be more worried.

The second issue is this idea that somehow South America, or SAFTA wrapped around Mercosur, will be able to bargain better with NAFTA or the United States. My question is, “Bargain on behalf of what?” On behalf of a more shallow integration—is that what we are bargaining on behalf of? Certainly, as things stand now, Mercosur is a lot shallower than NAFTA. Frankly, I think this bargaining motif is based upon a misconceived notion of how to extract trade concessions from the United States, because, in power terms, even if you sum South America, there is still a huge asymmetry between South America, obviously, and NAFTA or the United States.

The CBI countries, all small, weak economies, have managed to convince the United States to offer unilateral, nonreciprocal trade preferences. How did that happen? It happened because the arguments were essentially strategic and political, and that ultimately is how you extract economic concessions in the hemispheric context, I would argue, from the United States. Thererin lies the value of the summitry process for Latin America: The extent to which Latin America appears willing to cooperate with the United States on an array of issues important to the United States—from democracy to environmental issues, narcotics, etc.—that is the leverage for agreement on trade issues, not some sort of traditional bargaining-power model.

With regard to timetable and style of negotiations, we are headed toward an all-parties WTO-style format. Everyone will be sitting around the negotiating table at this point, but we all know that the real deal will be cut in an anteroom between the United States and Brazil. So the exact form and modalities of the regional negotiations are less important, I think, than would seem to meet the eye.

Brazil can and should maintain a leadership process in this, but Brazil will want to keep pace with the interests of other Latin American countries, and that pace will, in turn, depend very much on whether or not the United States itself moves forward. If the United States signals its willingness to proceed with hemispheric trade liberalization, that will rekindle the desire and the interest in many Latin American countries to move forward in an accelerated way to realize the hemisphere-wide free-trade ideal.

My final point with regard to timetable: In Miami it was agreed that the negotiations should be completed by 2005. That is what 2005 is, not that free trade would be implemented in 2005. Implementation can occur over 15, 20 years, whatever the exact NAFTA-style, prolonged timetable allows. It could be quite gradual implementation, but the key point is that the accord should be negotiated in the year 2005. That is what has been agreed upon.

The Canadians have suggested that the completion of negotiations be moved up to 2003, and that 2005 be the date whereby the agreements are ratified by the various congresses or other political processes within countries.

Let me say something really shocking here and take that one step further. Why don’t the leaders when they are in Santiago say, “Look, deadlines should be action-forcing events, not excuses for postponements.” Now 2005 has become an excuse for postponement. Why not say we will negotiate agreements—not implement them—by the year 2000? Nobody is going to frighten all the firms that are still consolidating in Mercosur with the specter of immediate free trade. Firms can have considerable time before trade barriers are actually further reduced, but why not suggest or agree in Santiago that the trade negotiators should seek to reach an agreement on hemispheric free trade by the year 2000?

That, incidentally, was the original Argentine proposal on the table in 1994, supported by Bolivia as well as other countries, but neither the United States nor Brazil wanted to accelerate free-trade talks. I think now the time has come. There is time between now and 2000 to negotiate
the technical details. During last two or three years, time has not been wasted; the foundations for successful negotiations have been laid. A lot of data have been gathered. A lot of studies have been completed. A community of trade negotiators has been created. The private sectors have been mobilized. The foundations have been laid, I would argue, for a negotiations that could be completed by the year 2000.

This timetable would have another important political advantage, and here, I think, Jagdish Bhagwati put an important point on the table. You have to appeal not just to the vanity, but to the legitimate political interests of leaders. Right now President Clinton has to expend political capital to get fast track. He gets no benefit because that is down the road in the year 2005. You move the payoff up to the year 2000, and, in effect, hemispheric free trade becomes a legacy of President Clinton. The same would hold, by the way, if we assume that President Cardoso succeeds in his re-election bid in Brazil. The same political calculus would hold for him.

I want to emphasize that I am not talking about implementation in the year 2000. I am talking about conclusion of negotiations. That strategy should not disrupt Mercosur, nor would it disrupt negotiations that might be ongoing with the WTO. They can all be seen in the context of political competitive liberalization. Liberalization in one area, as occurred in the late 1980s, pushes liberalization in another area. So I think they are consistent. They move all toward a positive convergence.

The issue really is will President Cardoso and will President Clinton have the political strength and the courage to seize the historical moment.
The Future of Regional Integration

ROBERTO FRENKEL

It is impossible to discuss the unforeseeable; however, it is possible to discuss our opinions regarding the future, provided that these are based on projections of current trends and the projected occurrence of events that we have grounds to assume are probable. The subjects of such a discussion would be the relevance and likelihood of such trends, the logic underlying the deductions drawn and the probability that the events hypothesized would occur. We assume that the objective of the organizers of the seminar, in planning this roundtable, was to elicit this type of opinion and dialogue.

As is customary in our profession, we will first consider the long term. Although we economists do not normally assign any specific length to this period, let us say—for the sake of presenting our views—that we are talking about a space of 20 years. We believe that over that time the Western Hemisphere, from Canada to Chile and Argentina, will essentially become a free-trade area. The basis for this belief is as follows.

First, and quite obviously, there is the U.S. policy initiative directed toward this objective. The project has remained in place during the transition from a Republican to a Democratic administration, and shows all signs of reflecting the U.S. strategy vis-à-vis the region. Protectionist elements in that country may occasionally slow the pace of the process, but it seems unlikely that they can stop it.

Second, a push in the same direction is coming from the increasingly international orientation of firms operating in the region. In the 1990s foreign direct investment and investment by multinationals accelerated, and this trend seems set to continue in the future. This increases the pressure and incentives toward regional integration.

Third, international financial integration on the part of the various countries and the availability of financing to cover current account deficits facilitate increases in trade flows while at the same time generating forces favorable to trade integration. The most noteworthy aspect of the 1990s is the North-South capital flow resulting from deregulation in the South and diversification toward the region in the North; however, the South-South international financial diversification process that is now underway is by no means negligible.

An additional word needs to be said about the effects of international financial integration on trade integration. The second half of the 1970s was characterized by trends similar to those we have seen appearing in the 1990s, but those earlier trends were suddenly interrupted by the debt crisis. The crisis caused a sharp decline in imports and a partial reversal in the opening up of trade. Tariff increases and the reimposition of trade restrictions were, to a large extent, brought about by the lack of external financing, but those measures encouraged the regional integration process.

Obviously, the accelerated financial integration process of the 1990s has not been devoid of crises, and there is no

Roberto Frenkel is Director of the Centro de Estudios del Estado y Sociedad (CEDES), Buenos Aires, Argentina.
guarantee that similar problems will not occur in the future. Nevertheless, the outcome and consequences of these later episodes have been different, because there have been appropriate reactions on the part of the U.S. government and the multilateral financial institutions. Some degree of contagion occurred, but such effects were limited and comparatively brief. These two factors together made it possible to overcome the crises and avoid the sort of consequences suffered in the early 1980s. Our view of long-term trends is based on the hypothesis that if new financial and external crises occur in the countries of the region, they can be solved in a similar way to the problems that affected Mexico and Argentina. If this opinion is turned around, we can regard it as a conditioning factor: Trade integration can continue provided there is no new version of the financial rationing that was applied in the 1980s. It is worth stating the issue this way because much remains to be done in this regard.

The final point is that the long-term trend toward integration of the continent is now an integral component of the vision and planning of Latin American governments and of the main political currents in the various countries. There are certainly a few exceptions, but overall we consider this to be an accurate assessment. In our opinion, the trade policies applied and planned by individual countries or reflected in subregional agreements are not conceived as permanent arrangements, but as stages in preparing themselves to reach the long-term goal.

We will now turn aside from our consideration of the long term and examine a more immediate future than those events 20 years away. In analyzing less remote time frames, we have to examine trends in greater detail. Inevitably, this limits the scope of our considerations, and so from here on we will concentrate on Mercosur.

Let us begin by saying that trade integration in Mercosur is also favored by those same regional economic trends we described earlier—i.e., the increasingly international character of firms and the increase in international financial integration, both North-South and South-South. Let us also say that the final point referred to previously—the long-term movement toward continental integration—is particularly valid in the case of Mercosur. We believe that the member governments see the agreement as a means by which they can become more competitive by the time they eventually broaden their trading arrangements. More specifically, we believe that the Brazilian government, in its approach to this process, has a more developed strategy, seeing Mercosur as a buttress in the negotiations that will finally lead to the integration of the continent.

Before examining the economic trends leading us to our conclusions on Mercosur's future, we should mention some aspects of the political context. As in the case of the European Union, the original motivation for the Mercosur agreement was political rather than economic. Even though the economic advantages were certainly in evidence, they were in the background. In the second half of the 1980s, trade integration was not a priority for the economic ministries of the various governments, since they were engrossed in dealing with the more urgent issues of stabilization, adjustment and negotiations with banks and international institutions. The fresh impulse shown by the agreement in the 1990s, together with a considerable increase in trade flows, caused the process to figure more prominently on the agendas of the economic ministries, and it demanded greater attention; however, to some extent the conditions we identified as characterizing the 1980s continued into the 1990s. Moreover, on several occasions the economic ministries of Argentina and Brazil tended to look on the agreement as an encroachment on their room to maneuver, which they wanted to use primarily for dealing with the complex problems of macroeconomic stabilization. Whenever conflicts arose, political will was the main factor ensuring that the integration process would continue and would deepen.

After the Treaty of Asunción was signed in 1991, the integration agreement speeded up, and trade flows also increased considerably. While total exports from Mercosur countries increased by 63 percent from 1991 to 1996, trade among them increased threefold, rising from 11 percent of exports in 1990 to 21 percent in 1996. Over this period, there was an increase of about 350 percent in Argentine exports to Brazil and Brazilian exports to Argentina. This statement should be qualified, however, because the apparently symmetrical pattern of flows between the countries was offset by the total volumes of their external trade, so that in 1996 Argentina's exports to Brazil constituted 28 percent of its total sales abroad, while Brazilian exports to Argentina amounted to only 11 percent of such sales. This is an important point with regard to the comparative share of Mercosur trade in each of the countries, and it plays a role in negotiations.

In addition to the sharp increase in the volume of trade, other signs that the integration process is strengthening
are that manufactured goods predominate, and that most of this is intra-industry trade.

These trends cannot be attributed exclusively to the integration agreements. The individual economies of both Argentina and Brazil have undergone wide-ranging transformations and macroeconomic changes that help account for these effects. First, each of these economies was liberalized and opened up in the 1990s. Between the end of the 1980s and 1994, the average nominal tariff in both countries was reduced to about half of its previous level—to 14.3 percent in Argentina and 13.2 percent in Brazil. The schedule of preferences in force until the end of 1994 was applied to these tariff reductions.

Second, stabilization programs were launched in both Argentina (in 1991) and Brazil (in mid-1994), and these led to exchange-rate appreciation and a considerable expansion in domestic demand. In both countries, there was a large increase in imports from all sources, including their Mercosur partners. From 1991 to 1996 there were 187 percent and 153 percent increases in total imports into Argentina and Brazil respectively. In light of this, the relative impact produced by the integration process can best be estimated by observing changes in the proportion of imports originating from Mercosur partners. In the case of Argentina, imports from Brazil increased from 15.2 percent of total imports in 1991 to 22.4 percent in 1996; in the case of Brazil, imports from Argentina rose from 7.6 percent of the total in 1991 to 12.2 percent in 1996. Nevertheless, not all of this increase in trade can be attributed to the policy of integration, because it is also necessary to take into account the advantages resulting from the countries' geographical proximity (at a time when imports were rapidly expanding).

An alternative method of assessing the comparative importance of macroeconomic effects, on the one hand, and effects resulting from the unilateral opening of trade, the integration program and geographical factors, on the other, is to make a regression analysis of the increases in imports coming from a given country's trading partner, as explained by changes in the real exchange rate and income, and including a dummy variable (value = 1, from 1991 onward), thus making it possible to identify the effects of trade policies and geography. We performed such an analysis using annual series over the 1971–95 period, obtaining a satisfactory degree of adjustment and highly significant coefficients. In both cases the dummy variables were significant, indicating that effects other than macroeconomic factors played a substantial role. In the case of Argentina's imports from Brazil, macroeconomic variables accounted for 55 percent of the increase, and the rest was attributable to other factors. In the case of Brazil's imports from Argentina, macroeconomic variables accounted for 37 percent of the increase. Given the importance of the macroeconomic effects, it should be pointed out that the usual indicators for trade specialization should be adjusted to allow for macroeconomic "noise," since the elasticity of demand with respect to income and real exchange rates cannot be assumed to be identical for all sectors.

The rising trend in internal Mercosur trade during the 1990s paralleled the general increase in imports resulting from the expansion of domestic demand and the rise in exchange rates, and it was facilitated by an abundant supply of international financing. In addition to the positive effects from the expansion of the markets for each of the countries' activities, the increase in intra-industry trade suggests that countries are taking advantage of the economies of scale and savings resulting from specialization. How can we assess the likelihood that this trend will continue and become sustainable? We have already indicated—and this bears repeating—that continued easy access to international financing, as under the conditions prevailing in the 1990s, appears to be a prerequisite for the integration process at continental and subregional levels. This is a general consideration applicable to the long term, but we can be more specific with regard to shorter time frames.

We know how difficult it can be to discuss issues of external financial sustainability and to make judgments regarding real exchange rates in the various countries, but we would venture to say that one undesirable consequence of macroeconomic stabilization policies has been that, with their current patterns of relative prices, the two largest members of Mercosur and the regional group, as an economic unit, face a trade-off between growth and external sustainability. In both cases, current account deficits tend to increase dangerously when economic expansion accelerates. Current export performance seems inadequate to sustain the accelerated increase in imports associated with comparatively high rates of growth. This restricts growth and the expansion of trade.

The governments of both countries have explicitly decided to rely on increased productivity to enable them to resolve this trade-off eventually, and on increases in capital
inflows to sustain their activities. Nevertheless, we know that that decision is partly the result of the problems perceived in each of these countries with regard to changing exchange policies. In addition to this trade-off, there is another—that between real exchange rates and stability—and the general view is that the cost of losing credibility by changing the rules of the game is very high.

The "tequila effect" indicates what the consequences would be of any unilateral change on the part of Brazil or Argentina. Past instances of resistance to the agreement, and the conflicts arising from it, also suggest that its very survival could be threatened if such an attempt were made.

The financial stability of all the member countries is now extremely important to each of them, as are the continuation of the integration process and the ability of each of these economies to sustain significant rates of growth. Because of the various incentives and difficulties that lie before them, we believe that the framework of the agreement provides the best opportunity for adopting a joint approach to the exchange problem. Moreover (and for the reasons we have presented), we believe that a multilateral approach is the only one that will enable the problem to be tackled in a way that will minimize costs and maximize the probability of successfully correcting distortions. We are well aware that coordination of macroeconomic policies is the least developed area in the negotiations, and we are also well aware that what we are suggesting is that the parties should deal with precisely the most difficult and thorny of all the issues facing them; however, we do so because of our conviction that this problem will inevitably have to be tackled at some time.

If Mercosur's external financial sustainability is guaranteed, the integration process that we have recently witnessed is certain to continue to consolidate and deepen.
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