Regionalism and the Global Economy

The Case of Latin America and the Caribbean

Edited by
Jan Joost Teunissen

FONDAD
The Hague

From: Regionalism and the Global Economy: The Case of Latin America and the Caribbean
FONDAD, The Hague, 1995, www.fondad.org

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Director: Jan Joost Teunissen

Regionalism and the Global Economy: The Case of Latin America and the Caribbean

Proceedings of a Seminar on Regional Economic Integration and Global Economic Cooperation: The Case of Latin America and the Caribbean, held at the Headquarters of the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) on 1-2 March 1995, organised by the Forum on Debt and Development, with the co-sponsorship of ECLAC.

Editor: Jan Joost Teunissen

The views expressed in this book do not necessarily represent those of the Forum on Debt and Development or the Economic Commission for Latin America and the Caribbean. Summaries of the floor discussions following the papers attempt to convey the sense and substance of what was discussed. They have not been reviewed by the participants.

CIP-DATA KONINKLIJKE BIBLIOTHEEK, DEN HAAG

Regionalism

Regionalism and the global economy: the case of Latin
America and the Caribbean / Roberto Bouzas ... [et al.] ;
ed. by Jan Joost Teunissen. - The Hague : FONDAD. - Ill..
Proceedings of a seminar on regional economic integration
and global economic cooperation: The case of Latin
America and the Caribbean, held at the headquarters of
the United Nations Economic Commission for Latin America
and the Caribbean (ECLAC) on 1-2 March 1995, organised by
the Forum on Debt and Development. - With ref.
ISBN 90-74208-06-1
Subject headings: Latin America ; economy / Latin America
; trade.

This publication was made possible thanks to the support of the Department for Development Cooperation of the Netherlands Ministry of Foreign Affairs.

Additional copies may be ordered from FONDAD at
Noordeinde 107 A, 2514 GE The Hague, the Netherlands
Tel: 31-70-3653820 Fax: 31-70-3463939 E-Mail: fondad@pi.net

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Abbreviations

ACP	Africa, Caribbean and the Pacific
ADR	American Depositary Receipt
ANCOM	Andean Common Market
AFTA	Asian Free Trade Area
APEC	Asia Pacific Economic Cooperation
ASEAN	Association of South-East Asian Nations
BANCOMEXT	Banco Nacional de Comercio Exterior (of Mexico)
BCIE	Central American Bank for Economic Integration
BLADEX	Banco Latinoamericano de Exportación
CACH	Central American Clearing House
CACM	Central American Common Market
CAF	Andean Development Corporation
CARIFTA	Caribbean Free Trade Area
CARICOM	Caribbean Community
CET	Common External Tariff
CNIE	Comisión Nacional de Inversión Extranjera (of Mexico)
CUSFTA	Canadian-US Free Trade Agreement
ECLAC	Economic Commission for Latin America and the Caribbean
EEC	European Economic Community
ERM	Exchange Rate Mechanism (European)
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
IDB	Inter-American Development Bank
IMF	International Monetary Fund
LAC	Latin American and the Caribbean
LACs	Latin American and Caribbean countries
LAFTA	Latin American Free Trade Agreement
LAIA	Latin American Integration Association
LARF	Latin American Reserve Fund
LDC	Less Developed Country
MERCOSUR	Southern Cone Common Market
MFN	Most Favoured Nation
NAFTA	North American Free Trade Agreement
NICs	Newly Industrialised Countries
OECD	Organisation for Economic Cooperation and Development
OECS	Organisation of Eastern Caribbean States
OPEC	Organisation of Petroleum Exporting Countries
SAFTA	South American Free Trade Area
TNC	Transnational Corporation
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
US	United States
USTR	United States Trade Representative
WTO	World Trade Organisation

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Preface

Regionalism has become fashionable in many parts of the world. After a period of about four decades in which the European Community stood out as practically the sole example of ongoing, successful economic integration, the regionalist fever has spread rapidly all over the globe. According to the World Trade Organisation, more than thirty regional deals have been signed between 1990 and 1994. Regionalism is not only on the rise within regions but even between regions, as is demonstrated by the example of the Asia Pacific Economic Cooperation (APEC) agreement between the United States, Japan, China, Taiwan, Malaysia, Australia and a dozen other countries bordering the Pacific Ocean.

Not everybody is happy with the surge of the "new regionalism". The criticisms come from two sides. On the one hand, there are the advocates of a free market world economy who argue that any regional deal presents a threat to international free trade. On the other, there are the critics of the globalising market eonomy who argue that the "new regionalism" is just another expression of the same trend of economic liberalisation and globalisation, and therefore has the same negative effects on the social, ecological, cultural and political conditions of countries and peoples within the regions.

Others, however, argue that it is precisely the new "open" regionalism which may give new impulses for a more just and better functioning system of multilateral cooperation. In their view, regional integration of the right kind is an essential intermediate step towards genuine international cooperation in which the developing countries and the transition economies will carry more weight than at present. Moreover, they see regional economic integration as an important way for most developing countries to develop their economies in a more satisfactory manner under the new market-based development paradigm.

The views presented in this book fall mostly into the latter category. They seem to be inspired by the assumption that the new "regionalist" mood is likely to stay and that it is therefore both interesting and necessary to study and discuss the phenomenon, and suggest ideas and policies that may help overcome current problems.

Many books and articles have appeared recently on the topic of regional integration in Latin America and the Caribbean. Yet the debate is far from concluded. There is not only a lack of consensus but also a lack of factual information on important aspects. By focusing the research primarily on

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financial issues and by reporting extensively on a two-day discussion between experienced researchers and policymakers which was held at the Economic Commission for Latin America and the Caribbean (ECLAC) in Santiago de Chile, with the present volume Fondad hopes to make a contribution to both providing new information and shaping new opinions.

This book arises from a three-year research project set up by Fondad, which aims to explore how regional integration as well as multilateral cooperation can be promoted, in a mutually reinforcing manner, at the same time. The four papers presented in this volume are all written by experts who work in developing countries or come from such countries themselves.

Percy Mistry, an economist from India who has a remarkable knowledge of both public and private enterprise, presents a thought-provoking and broad view of the problem. One of his observations is that there is a critical need for a new analytical framework to assess the costs and benefits of regional integration. Stephany Griffith-Jones, an outstanding economist from Chile who has specialised in financial policy matters, explores the little-researched financial aspects of Latin American integration. Ricardo Ffrench-Davis, a leading economist of ECLAC who has gained a reputation in both academic and policy circles, focuses on the crucial role of intra-regional trade. Finally, Roberto Bouzas, a prominent economist from Argentina, reviews the challenges posed by the "regionalist" revival in the Western Hemisphere. In particular, Bouzas looks at the policy dilemmas and prospects posed by the North American Free Trade Agreement, NAFTA.

Each of the four papers is followed by reports of the floor discussions that took place in the Santiago conference. Two remarks about these reports are in place. First, they do not cover all the interesting issues that were raised. A debate about the Mexican currency crisis of 1994, for instance, could only be partially covered. In this case, however, the omission is redeemed by another Fondad booklet (on the lessons from the Mexican crisis) which will be published soon. The second caveat is that the conference participants have not reviewed the reports of the floor discussions.

Fondad gratefully acknowledges ECLAC's co-sponsoring of the conference in Santiago, and the support of the Dutch Ministry of Foreign Affairs. We are also grateful for the solid and spirited contributions by the participants to the Santiago conference. I regret that one of them, Shahen Abrahamian, has passed away. We will miss his company. Special thanks go to Ricardo Ffrench-Davis, Stephany Griffith-Jones and Percy Mistry who were of great help in preparing the conference from which this book results.

Jan Joost Teunissen
Director
October 1995

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Open Regionalism: Stepping Stone or Millstone toward an Improved Multilateral System?

Percy S. Mistry

Introduction

Is regionalism a *building block* or a *stumbling block* to an improved, multilaterally open trading system? That issue is not a new one. It has resonated over the last forty years with sporadic increases in intensity at different points during that time. Recently, it developed particular pungency when the Uruguay Round looked as though it might fail. A large number of people in the multilateral system – most prominently the eminent international trade economist Jagdish Bhagwati, who is also an advisor to GATT – became extremely concerned about the competitive threat of regional initiatives to the successful conclusion of the Uruguay Round. However, after that Round was concluded and ratified, some of the concerns raised have died down. Correspondingly the more artificial, contrived arguments that were raised against regionalism as a spectre have also begun to moderate or recede. Today the argument has perhaps entered a slightly new and different arena. The question of regionalism vs. multilateralism has broadened from a narrow question of their respective effects on trade liberalisation *per se*, to embracing and encompassing a much broader, more diverse range of issues. Indeed trade has become only one part and perhaps not even the most important part of the new regional vs. multilateral debate.

The thoughts developed below will:

- reflect on the facile, implicit assumption invariably made that the terms "regionalism" or "regionalisation" are antithetical, second-best, inferior or sub-optimal option, if not pejorative, while the terms "multilateralism" or "global liberalisation" invariably convey a sense of something positive, first-best, superior or optimal;
- offer a heretical, provocative hypothesis that open regionalism may not only be *conducive* to more effective multilateralism in the future, but may actually be an essential *prerequisite* to a new multilateralism of a more workable kind;
- focus on the reality that the highly imperfect kind of multilateralism (the old multilateralism) that exists today is probably dysfunctional in accom-

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modating satisfactorily the kaleidoscopic economic and political transformations that are occurring in the world; and that a new multilateralism will need to emerge before it can offer a superior option to the new regionalism;

- consider what is happening, and is likely to happen, to rapidly changing patterns of world trade and their associated economic interactions between 1995 and 2025;
- suggest why nations are resorting to a record number of arrangements at the *regional* level while giving the *multilateral* process some much-needed breathing room to revive and adjust;
- consider some of the conditions necessary for regionalism to reinforce and support, rather than to impede multilateralism; and examine why the new regionalism will support the emergence of a new multilateralism rather than inhibit it; and finally,
- offer some concluding observations.

The New Regionalism is Different from the Old Regionalism

One of the more striking things that a careful review of recent literature on regionalisation reveals is the staggering volume of its production from different sources. To cite but a few major recent initiatives: the United Nations University's World Institute for Development Economics Research (UNU/WIDER) is about to complete a major project; the Organisation of Economic Cooperation and Development (OECD) has completed at least five separate studies by five separate groups; the General Agreement on Tariff and Trade (GATT) has concluded a survey on a range of regional vs. multilateral issues; the Royal Institute of International Affairs (Chatham House) recently produced a major book on the subject; the World Bank and the IMF have ongoing policy research programmes on regional integration; and so do the UN's regional economic commissions and the regional development banks. And these projects do not even begin to include the ongoing work being done in academia all over the globe! The amount of literature that is emerging on this issue is thus both overwhelming and bewildering. Little of it is very good; most of it is quite confusing and conceptually unsound if rhetorically quite exciting.

What is also striking is that in discussing the new, open regionalism (and whether it is a threat or not to multilateralism), different sources appear to be talking about entirely different concepts. There is an absence of definitional focus on what the new regionalism actually is. For example, Professor Björn Hettne from the University of Gothenburg, (who is directing the UNU/WIDER project), defines the new regionalism as a multidimensional process of regional integration which includes economic, political, social and cultural

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aspects[1]. His stress is much more on the non-economic, on the political and security dimensions of regional integration. According to Hettne, regional integration is a package rather than a single policy, whether concerned with economics or foreign policy. The concept – as defined by Hettne, and it is difficult to disagree – goes well beyond notions of free trade areas and market integration, i.e. the linking of several national markets into one functional economic unit. Political ambitions of creating territorial identity, political convergence, collective security and regional coherence now seem to be the primary, neo-mercantilist goals of the new regionalism. Another difference with the old regionalism, according to Hettne, is that the new regionalism is spontaneous and from below (firm, market and consumer driven), whereas the old type was imposed from above (bureaucratically fiat driven) and was therefore more limited and more prone to failure of the kind that *grand designs* invariably suffer.

At the other end of the scale, The World Bank, in a recent study authored by Carlos Braga,[2] while overtly recognising the importance of non-economic considerations in driving the new regionalism, still chooses to treat the new regionalism as an economically enhanced free trade concept. The enhancements are essentially the following: liberalisation of trade in services, liberalisation in movements of capital and labour; harmonisation of regulatory regimes; and the emergence of North-South regional arrangements which are now becoming the rule rather than the exception. Braga recognises that there is a clear shift of inward looking emphasis in South-South arrangements from being closed and aimed at the wrong objectives (protectionist) to being open and aimed at the right ones (outward oriented and competitive). Finally, Braga points to one key feature of the new regionalism: i.e. that it underlines non-exclusivity, or more accurately, inclusivity, as opposed to a regionalism which once used to be defined in terms mainly of which barriers members of a regional group could erect to thwart non-members, and how high these barriers were to be.

Thus, the argument about regionalism vs. multilateralism in the mid-1990s (post-Uruguay) is quite different from that of the early 1990s (pre-Uruguay), depending of course on who is making it. The discussion is now more holistic than it was even a few years ago, when people simply analysed regionalisation from the view point of whether regional trade agreements were going to get in the way of concluding the Uruguay Round. It is becoming increasingly apparent that the non-trade aspects of regionalism – which have invariably

1 Hettne B. and Inotai, A., "The New Regionalism: Implications for Global Development and International Security", UNU/WIDER, Helsinki, 1994.

2 Braga, C., 'The New Regionalism and Its Consequences", World Bank (IED), Washington DC, August 1994.

been underplayed by trade economists who have monopolised debate on regional integration since the invention of Vinerian analysis in the early 1950s[3] – may even be more significant than the trade related aspects of the process.

A Heretical Hypothesis

The general explanation – offered by traditional trade economists – of why regionalism has boomed in recent times, is that the United States has converted itself from being a committed free-trading multilateralist power to becoming a regionalist power mainly to counteract the emergence of threatening competitive trade blocs in Europe and Asia.[4] A second reason for the rise of regionalism concerns the demonstration effects of what has been happening in the European Union; whether positive or negative, relevant or irrelevant, European integration has had a powerful influence on the way most countries are thinking about regionalisation. A third factor is that after the developing country debt crisis of the 1980s a whole new market-related ethos of outward-orientation and liberalisation has affected economic policy in developing countries in a way it had never done before. That happened both because of internal conviction on the part of a new generation of market-oriented policymakers and because of external compulsions transmitted through the IMF's and World Bank's adjustment programmes. Fourth, there was also a growing notion, particularly after 1989, that the breakdown of the Cold War order brought to the fore simmering problems with hitherto untouched taboos about the sovereignty of the nation-state and its capacity to make the kind of independent economic and political decisions it once used to.

To these four more or less widely accepted reasons there is perhaps yet another explanation to be added, which, to those steeped in the traditions, values and beliefs of the multilateral system, may seem heretical. Though many committed multilateralists instinctively portray regionalism as being antithetical (if not dangerous) to multilateralism, they overlook the reality that there may be a perfectly natural and sensible reason why regionalism at the moment seems to be more user-friendly to the average small or medium sized nation-state (whether developing or developed). That reason lies in the reality that the multilateral system as presently constructed is functioning with an increasing degree of imperfection, uncertainty, inefficiency and

3 Viner, J., *The Customs Union Issue*, Carnegie Endowment, New York, 1950.

4 See, for example, Bhagwati, J. "Regionalism and Multilateralism: An Overview", In: de Melo, J. and Panagarija, A. *New Dimensions in Regional Integration*, CEPR, Cambridge University Press, Cambridge (UK), 1993.

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ineffectiveness. Dominated as it is, and often distorted as it is, by faltering great powers, who can no longer exercise real leadership, and whose capacities are focused on obstructing rather than constructing, that system is no longer sufficiently well-structured, nor responsive, nor adaptable to the needs of a changing world order; one in which old verities have given way to new uncertainties.

The present multilateral system of global interaction and transactional governance thus looks weak and tired; its institutions are too rigid and unbending and its myths are as yet incapable of adapting to new global geopolitical realities. By and large, despite the successful ending of the Uruguay Round and the establishment of the World Trade Organisation (WTO), the feeling is that present-day multilateralism, and machinery which serves it, are grinding slowly to a halt. There is no longer a universal belief in the efficacy of, or even the need for, the United Nations. More than half of the world believes strongly that the Bretton Woods institutions detract from, rather than enhance, global welfare. Many believe that these institutions have become vested interests in their own right, more concerned about self-preservation than with the evolution of their mandates, roles and functions to adapt to new circumstances. It is therefore a plausible hypothesis that the new regionalism is being resorted to because the old multilateralism does not seem to work any longer; at least not for the benefit of most of its members. That is a hypothesis that needs to be put on the table and subjected to careful scrutiny. Open regionalism may not therefore just be *conducive* to more effective future multilateralism, it may actually even be a *prerequisite* for building a new multilateralism of the kind that more properly reflects the changes that have occurred in global balances of geopolitical and economic power.

This hypothesis, like any other, is of course an arguable one. It is not a hypothesis that has appeared so far in the wealth of recent literature on regionalisation vs. multilateralisation. The literature still tends to assume that regionalisation is *per se* bad and multilateralisation is *per se* good – an issue which will be revisited throughout this paper.

The Problem with Today's Multilateralism

Why does the old multilateralism no longer seem to work? First, because there are fundamental design flaws in its architecture and its construction. The old structure was built primarily by the United States to serve a visionary purpose which has since been substantially eroded in the US itself. The United States is no longer the force, globally and economically, it once was; it can no longer impose its will on the world either by persuasion or by force. Former subservient client states have become powerful economic competitors

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even as they appear to remain political and military allies. Countries that are still developing have become major military threats. Yet the United States' willingness to cede power, and to share it with others in a more genuinely multilateral system, poses severe problems, as does the increasingly widening gap between positions taken by the US Administration and the US Congress on issues that affect the rest of the world. The conflict between those two poles of political power within the US is one which the rest of the world finds increasingly difficult to cope with or accommodate. And the US being the US does not really appear to care about that problem as much as it should. Even when the US chooses not to play a dominating role in the system, it leaves a void which cannot be easily filled simply because there has been no experience with any other nation, or group of nations, filling it in a way that would be seen as legitimate or acceptable. The reluctance of the US to cede power is mirrored in the equal reluctance of Europe and Japan to assume a proper share of global responsibility. We thus have a multilateralism in which the US still calls the shots, Europe and Japan pay the bills, and the rest of the world is largely unempowered and dispossessed.

Second, Europe, which is presently paying the largest share of the multilateral system's costs (especially for the non-security related part), has not shown much ability or inclination either to provide direction or to set the agenda for the multilateral system. On issues of cross-border trade, finance and labour market movements, Europe still acts as the most inward-looking, restrained and defensive part of the world. It is still more statist rather than market-driven; more so than most other regions. In Europe social concerns often outweigh market realities. Moreover, a confused set of signals is coming from Europe, arising out of three major issues which appear to preoccupy Europeans: (a) there is a resurgence of an almost petty form of nationalism in the still evolving European Union, which has suddenly raised fundamental questions about integration threatening to slow down the trajectory and pace of the next round of deepening and widening various integration processes within Europe; (b) the issue of subsidiarity remains unresolved with a lack of clarity about what kind of decisions should be made at what level; and (c) there is considerable discord between the confused voices of the individual nation-states of Europe vs. the collective regional European stance put forward by the European Commission, which often seems out of time with ground-level political realities. Put simply, Europe has a problem with the multilateral system because it speaks with both 15 voices and with one voice and those voices invariably do not say the same things on any set of issues whether economic, political or cultural.

Third, there is the Japanese problem. Up to three or four years ago Japan and the rest of the world were convinced that the Pacific century had dawned and that the centre of global gravity had shifted from the mid-Atlantic to the mid-Pacific. One of the problems of the old multilateral system was reflected in the extreme difficulty which Japan experienced in being accepted as a fully-fledged member of a formerly exclusive US-European, largely Anglo-Saxon dominated club. Amazing as it now seems, it took twenty years for Japan's position as the world's second ranking economic power to be recognised within the rigid structure of the established multilateral system. Yet suddenly Japan, having shoved and bought its way into the second slot, has now become a very weak and unconfident part of the multilateral nexus. This is partly explained by the breakdown of its traditional domestic political system, which is moving from a phase of stability, predictability and "discipline" to a more Western-style phase of fractious, confrontational and histrionic democracy which, when laid bare, appears too sleazy, corrupt and opaque even by the standards of developing countries.

Fourth, the implosion of the second or "communist" world in 1989 has dramatically changed traditional views of multilateralism. Like it or not, the old multilateralism – especially in matters of military security, economics, trade and finance and the institutional structures set up to deal with those four major global issues – was shaped entirely by the contours of the Cold War. At the end of the Cold War, a world order established for nearly half a century has broken down. It is becoming increasingly clear that the characteristics of the multilateral system which the world has today are neither appropriate for, nor conducive to, the graceful and unproblematic emergence of a new world order more suited to accommodating and absorbing previously communist and developing countries into the framework of developed market economies. Instead the transition is proving very troublesome. Former second world countries have had to descend to third world standards of living before re-gearing themselves to become part of the first world to which they believe they rightfully belong.

Finally, and this may be a geopolitical phenomenon of some significance, all over the developing (third) world there are serious – more serious than in the past – questions now being asked about whether developing countries either need, or benefit significantly from, the kind of ineffectual, insipid multilateralism which exists today. A new sense of confidence and assertiveness has emerged in the Third World which seems to be rooted largely in three decades of untrammelled growth in East Asia and the realisation in Latin America in the 1990s that there is indeed "life after debt", the recent hiccup in Mexico notwithstanding.

Developing countries, especially in Asia and Latin America (but much less so in Africa), are now deploying the laws of *realpolitik* in defining their own national and regional interests and pursuing them quite differently and more aggressively than before. They are no longer willing to accept the kind of multilateralism in which their growing economic and littoral power is neither

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adequately recognised nor reflected responsively enough in the present global multilateral framework. For them, the formation of their own regional blocs reflects a desire, and the will, to be taken much more seriously as economic partners by the developed world rather than as undeserving recipients of OECD largesse. Their patience is being stretched as they continue to be patronised and condescended to by OECD countries as second or third class world citizens with fewer rights and privileges than the first class ones. Having been kept out of meaningful decision-making in the more exclusive OECD-dominated clubs, it is not unnatural that they are now intent on setting up a few of their own in which they have a greater say in making the rules and suiting their own convenience.

Trends in Global Trade and Cross-Border Investments

To these five global geopolitical forces – which are causing shifts in the tectonic plates which underlie the international economic system – the following realities must be added to establish a clearer perspective on the future:

- Between 1945 and 1985 the most rapid growth in world trade in goods and other economic transactions (finance, services, technology transfer, the globalisation of production, the development of global marketing and global brands) occurred within the North. Between 1945-65 such growth was primarily Atlantic-focused. The centre of economic gravity lay somewhere between the US and Europe. Between 1965-85 it spread to a wider US-Japan, Europe-Japan, and intra-European growth dynamic with spillover effects for the rest of the world. The centre of economic gravity started shifting.
- In contrast, between 1985-2005 the largest growth in world trade and other economic transactions is already occurring and will continue to occur in transactions between North and South. The fastest growth is in Asia, especially between Japan and East Asia, within East Asia, and between East Asia and South Asia. Post 1994 there is increasing growth in transactions between Western and Eastern Europe; between Europe and the Middle East; and between Europe and Africa. In the Western Hemisphere the same surge is being seen between the US/Canada in North America and the other southerly countries in that hemisphere.
- If present trends continue, after 2005 and up to 2025, the largest growth in world trade will be mainly in South-South trade, especially within (and to an increasing extent even across) Asia, Africa, Latin America and the Caribbean, and the Middle East. Between 2005-25 the centre of global economic gravity will shift inexorably from Northern to Southern transactions as these account for the most rapidly growing sources of world

interaction. If present trends continue (especially in the growth of the populous economies of China, India and Indonesia) the developing world which accounted for 20% of real global production in 1950 and 40% in 1980 will account for over 60% of global production by 2015 and probably more than two-thirds by 2025.

The unresponsiveness of the present multilateral system in accommodating itself to the new role that developing countries are playing in the world economy provides a large part of the explanation for expanding experimentation with more fluid and imaginative arrangements which are regional in nature. Developing countries are doing it themselves rather than attempting to deal with a multilateral system which continues to be dominated by ageing economic powers and not responding in the way that it should to rapidly changing circumstances.

Dysfunctionality: The "Void"

Although new forces in the world economy have already been unleashed and a new set of dynamics is underway, the global machinery required to handle and channel them productively is not yet even in the incipient stages of design. It seems as if, without the world having articulated its thoughts too well, there is a broad recognition that something is necessary to fill the void being created by an increasingly dysfunctional multilateral framework. That "something" may well be more plurilateral, hybrid forms of regionalism. At the present time such hybrids appear to be a more reasonable, manageable and appealing alternative to many countries than what an ever-weakening and increasingly discredited multilateralism has to offer.

Why is that so? Is it just the case of the system instinctively moving one step backward now to move two or three steps forward later? Is it, simply, a matter of the recent conversion of the USA in overcoming its former philosophical aversion to regional trade blocs? Is it the equally strong but still implicit gnawing doubt that the concept of the economically sovereign nation-state itself may be under severe stress? And if so, can the present multilateral system – whose architecture was designed in 1945, whose constitution was shaped by the Cold War, and whose imperfect operations are based on increasingly deficient negotiations between unequal nation-states undergoing severe transformations – be viable for very much longer? Or is it simply that many countries have come to recognise the need to withdraw from global dreams into regional practicalities, not just as a matter of temporal convenience, but as a step that must be taken in order to rebuild the foundations of an entirely new and more functional framework and institutional structure for effective multilateralism?

There are, of course, no definitive answers to all these questions as yet. A

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suspicion is growing that the answer may well have something to do with the sudden global upsurge of regional cooperative arrangements in virtually every corner of the world. There is an even stronger suspicion that this upsurge is probably not just ephemeral but that nations are turning to regionalism as a practically more realistic and more feasible approach even if it is theoretically sub-optimal. To get to a new form of multilateralism, (which is an inevitability even though not yet formulated as a grand design) the implicit choice being made by nation states is to do it via the new regionalism.

What Kind of Regionalism Would Be Supportive of Multilateralism?

If the new regionalism is not to be antithetical to the emergence of a new multilateral order what kind should it be? Without indulging in a boring repetition of details, all of the major studies mentioned earlier have come up with specifications of the kind of regionalisation that would be conducive to multilateralism. Such characteristics include, for example: (a) the requirement that regional arrangements reduce simultaneously their external tariffs pro rata to the elimination of internal trade barriers; (b) consistency with WTO rules; (c) straightforward rules of origin; (d) non-discriminatory treatment of foreign enterprises; and (e) effective dispute settlement mechanisms.

But apart from such characteristics being designed into regional arrangements, there are other reasons for believing that the new regionalism will support the emergence of a new multilateralism. First, there is some evidence that the new regional arrangements already have certain built-in features which will make the emergence of more sensible multilateralism more likely than unlikely: in particular their openness and a new tendency towards inclusivity. Second, the new regional integration arrangements will eventually lay the foundation of regional institutional structures which are multilaterally friendly rather than multilaterally resistant because they are being driven by: (i) market forces rather than fiat; (ii) the needs and imperatives of transnationals which seek inter-regional strategic alliances rather than a universal presence of their own; (iii) technological innovation and information; (iv) the convergent demands of global consumers of goods and services in an increasingly global market place; and (v) the technology-driven shifts in global but still localised production processes. Third, by strengthening *plurilateral* processes in a framework which gives even the weaker nation-states some say in decision-making, the new regionalism will lead to the kind of multilateralism in which regional blocs will have stronger bargaining power with the Big-3 (i.e. the US, Japan and Germany) and will deal with these countries (and each other) on a more equal footing, thus replacing a multilateral system which is dominated by three "reserve currency" nations whose global significance is diminishing but which nevertheless continue to dictate the rules of the game to the other 195 nations of the world and which pass on to other countries the costs of delaying their own internal adjustments.

The new regionalism we are witnessing today is, in fact, both a product of structural globalisation (i.e. globalisation of production, marketing and consumption structures for goods, services and ideas) and is in turn feeding back to reinforce that same process of globalisation. Countries and regions which are presently better off than others will obviously resist the adjustments necessary to accommodate market-driven rather than fiat-dictated shifts in patterns of global production and income. But since their future growth and welfare will depend on the much more rapid growth of demand in less well-off countries and regions, those adjustments will have to be made eventually; regardless of how painful they are. Of course, the longer they are delayed, the more painful they will be.

Why Is There a Case for Being Optimistic?

The transitional path from a disintegrating old multilateralism towards a more durable, workable new multilateralism – in which the concept of global governance will be more than a cruel joke on humanity – is likely to be fraught with pitfalls and difficulties. It will involve going through regional experiments which will evolve and be refined over the next 20-25 years. Nonetheless, there is room for optimism that the new, more open regionalisation which is occurring world-wide will be benign to the cause of multilateralisation and to eventually effective global governance of international transactions.

One reason relates to the characteristics of the new regionalism. As noted above, it is being driven now by markets and not by policy, by fiat or by multilateral institutions (except perhaps in Europe) with vested interests. It is being driven by the forces of global corporatisation and global competition, by the globalisation of financial markets, capital flows, consumer demand, product/service brands; and by the global ease with which technology and innovation can now cross borders despite new requirements for the protection of international property rights. From that point of view, the very forces which are driving regionalism are compelling it to be globally-friendly and multilaterally-friendly. Providing that the right kind of new multilateral framework is created to maximise that friendliness, there is no reason why the new regionalism should prevent it from emerging and flourishing. The real difficulty with the transition may well be that the new regionalism will force a disruptive breakdown of the old multilateralism through a process in which regional blocs rather than individual nations play a more direct and decisive

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economic role in multilateral decision-making. The new multilateralism will be built with regional blocs being the key consultants in global decision-making structures, with nation-states having a direct say at the regional rather than multilateral level, as they do now.

Another reason for optimism is that overarching – not necessarily overlapping – regional arrangements are already beginning to emerge at tremendous speed. The Asia Pacific Economic Cooperation (APEC) group is a classic example. It now embraces the North American Free Trade Area (NAFTA) even before that bloc has been fully formed, and possibly will also embrace the emerging Asian Free Trade Area (AFTA) which will incorporate an expanded ASEAN. It may even embrace the emerging Latin American Free Trade Area (LAFTA) which includes Mercosur, the Andean Pact, Caricom and Central America. Thus supra-regional umbrellas are being created even before the more confined regional arrangements that they shelter have been fully formed, to make sure that the principle of ever-expanding inclusivity is not compromised.

In February 1995, another regional initiative emerged which few had given much thought to three weeks earlier. When President Mandela of South Africa visited India in January 1995 the Indian Ocean Rim Initiative was merely a notional concept put on the table for discussion. To everyone's amazement it quickly became a reality with rapidly emerging shape and form and with Australia and Indonesia being interested in becoming partners within that structure. It was extraordinary that this concept turned from idea to reality in just three weeks. Now there is much talk about the regional reintegration of the Baltic states, both as an Interim mini Community and as part of the larger Nordic Community. These examples suggest that the search for inclusivity and the commitment to avoid making any individual regional bloc a static entity which is basically protective in nature has fundamentally changed. The focus is much more on forming a club among members prepared to take bolder strides toward regional integration, leaving the door open for others to come on board as and when their domestic political circumstances and constituencies allow.

The increasing acceptance of the notions of "variable geometry" and "multi-speed" approaches to regionalism – which lend more flexibility to regional arrangements – is another reason for optimism. Most regional arrangements now seem to be less ambitious and much less bureaucratically inclined than they were earlier when such arrangements were the preserve of technocrats anxious to impose reality on their populations.

There are now explicit provisions in various multilateral organisations, particularly WTO and the regional development banks, to encourage the new regionalism. There is a strong tendency for reaching outwards, even by the three major blocs: NAFTA, the European Union and what is emerging –

and is wrongly seen as a threatening trade bloc – in Asia, to establish flexible association agreements with non-members.

The new economic regional arrangements are now taking into account *security* considerations as well; perhaps nowhere more so than in Europe. Emerging regional arrangements in the Middle East will hopefully also result in regional arrangements which actually anchor hard-won peace and security. Fortunately all the trends seem to point in that direction; another reason for being optimistic.

There is a proclivity, even on the part of large federal countries with large (almost continental) internal markets – Brazil, India, China, Indonesia – to consider regional integration as a serious alternative to the autarchic approach they have pursued so far. They do not see it simply as a mechanism to anchor their reforms and secure their new-found openness. They appear to believe instead that the whole concept of what constitutes a market in a world which is globalising very rapidly has changed. Even these large countries, to whom the economy of scale argument has never been that important, are worried about being left behind if they do not become active and enthusiastic members of a new global market regime

There is at the same time no evidence that the new regionalism, although it is a process which is really only about five or six years old, is thwarting *inter*-regional interaction. While trade within regions has grown dramatically in the past five years (especially in Asia and Latin America) it has not grown at the expense of trade *between* regions; that is another sign that the new regionalism will foster rather than thwart a new multilateralism.

The Need for a New Analytical Framework

What the evolving process of a new regionalism suggests is the critical need for a new analytical framework to assess the costs and benefits of regional integration. That framework needs to be more holistic in nature and not confined simply to issues and concerns about trade in goods. It is becoming quickly transparent that the classical Vinerean trade-theoretic framework based on the analytic constricts of trade creation and diversion – through which the costs and benefits of integration are invariably assessed – is much too partial, confined, and perhaps even occasionally misleading, to be satisfactory in drawing conclusions about the costs/benefits and consequences of the new regionalism. The Vinerean analysis – especially of the comparative static sort – can yield misleading impressions of what regional integration might really mean for the members of a regional arrangement because it does not include an assessment of the dynamic economic effects of integration nor of the *non-economic* benefits of integration.

In embracing the new regionalism as a multilaterally-friendly phenom-

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enon, there is a worrying aspect that cannot be ignored. The increasing prevalence of *macro*-regionalism (i.e. the regionalism comprising supranational economic regionalism) is also triggering a simultaneous form of *micro*-regionalism (i.e. regionalism within the nation-state) which is ethnically based. Nowhere is this occurring faster than in Europe, where the future of the nation-state itself – on which the present old multilateralism is based – is now being put under strain. A relatively smooth process of macro-regionalism among nation states is being accompanied by disruptive, often violent internal fragmentation within nation states. Indeed, it is possible that the opportunities which the new macro-regionalism offers is actually encouraging the fragmentation of nation-states forged under geo-political pressures which no longer apply.

Conclusion

The general points made above on whether the new regionalism will encourage or discourage the emergence of a new multilateralism can be put into context with the following two observations.

The first comes from the preface of a study by Charles Oman, which was published by the OECD.[5] He says that economists tend to see globalisation as a good thing and that, in looking at regionalisation, economists have therefore tended to focus on the question of whether regional groupings are likely to constitute building blocks or stumbling blocks for globalisation. Many other people, on the other hand, including national policymakers and their constituencies, especially now in the OECD, see globalisation as threatening. They see it as accelerating the pace of change to which they must structurally adapt, and over which they seem to have less and less control.

Another of Oman's observations is that, even more than in the past, the new globalisation tends to foster both *de facto* regional integration and *de jure* regional agreements among governments. "Regionalisation, in turn, tends to foster globalisation insofar, and only insofar, as it is allowed to stimulate the forces of competition within a region. The challenge for policymakers is to pursue regionalisation as a means to weaken the powers of entrenched national oligopolies and rent-seekers while responding to the growing need, engendered by globalisation, for deep international policy integration. And deep international policy integration is unlikely to occur without deep regional integration occurring first," Oman says.

5 Oman, C. "*Globalisation and Regionalisation: The Challenge for Developing Countries*", OECD Development Centre, Paris, 1994.

Add to that an observation by David Henderson,[6] who used to be Director of the OECD Economic Secretariat. He argues that two questions can be asked about the future of the world trading and investment system. First, will it become more open and more liberal? Second, will the extent and influence of regional trade blocs increase?

Contrary to what is often suggested, these two questions are distinct, Henderson observes. According to him the future of the mutilateral trade and investment system, and of international economic integration, will not depend on the extent to which regional integration agreements *per se* become more extensive or more deep-rooted, but rather on how far liberal rather than interventionist influences affect the evolution of external economic policies in the leading nation-states and trading entities, in particular the European Union and the United States. "Regional agreements will largely reflect this balance – i.e. the balance between liberalism and interventionism either at the national level or in the world as a whole – rather than determining it. That part of the current debate which portrays regionalism, on the one hand, and liberalism or multilateralism, on the other hand, as warring principles is misguided. A truer and more fundamental antithesis is the conflict between liberalism and interventionism, whether it be national, regional or global."

6 Henderson, D. "Putting Trade Blocs into Perspective", In: Cable, V. and Hudson, D. (eds.), *Trade Blocs? The Future of Regional Integration*, Royal Institute for International Affairs, London, 1994.

Floor Discussion of the Mistry Paper

Macroeconomic Stability

Manuel Marfan, Chile's Deputy Minister of Finance, in his opening address to the conference, stressed that the new process of economic integration in Latin America has been largely the result of the economic reforms of the 1980s. According to Marfan these reforms have diminished the heterogeneity of the ways in which the Latin American economies operate, and this reduced heterogeneity, in turn, has eased the process of economic integration.

"One of the characteristics of the Latin American region in the last decades was precisely the volatility of the rules of the game. This is one of the main reasons why intra-regional trade in Latin America has been so low compared to other regions. The economic reforms of the 1980s have created a consensus on the need to base growth on investment, savings and exports, especially non-traditional exports. This consensus has stimulated private producers and investors to start operating in different markets, thus establishing more solid and more stable relations between countries. The first element of successful integration is therefore stable economic relations and stable rules of the game."

A second crucial element of successful integration was, in the view of Marfan, macroeconomic stability.

"It is useless to reduce tariffs from say 30 per cent to 15 per cent when subsequently the real exchange rate moves 50 per cent or more. There are many examples of countries in the region which initiated efforts to increase their bilateral trade and immediately after they signed an agreement one of them started developing an economic package which introduced a lot of noise in its internal macroeconomic events including relative prices which affect trade. One important way to strengthen economic relations in the region is therefore a common effort to stabilise our economies. By stabilising I mean stabilising mainly relative prices, which is important in order to create a less risky environment for private agents," Marfan said.

Augusto Aninat, president of a large Chilean export firm, wondered whether Marfan's emphasis on the need for macroeconomic stability would mean that a new component was to be added to the definition of a region.

"What is a region?" Aninat said. "I think the components of the definition are changing. In the past, a region was geographically defined. Neighbour-

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hood was very important. Secondly, it had to do with socio-cultural elements in common. But today new components are added such as the one given by Marfan: macroeconomic stability. I think this change in the definition of a region is important."

Hector Assael, chief of the International Trade, Finance and Transport Division of ECLAC, argued that the main issue in the coordination of macroeconomic policies is the achievement of stable exchange rates.

"If you have a stable real rate of exchange, you are in a good position to solve problems. If you take, for instance, the case of the 'Crónica de una muerte anunciada' of Mexico and Argentina, it is very clear that because their real rate of exchange has been going down all these years, there is trouble. It is not because they had a good policy or a bad policy, but because they had a real rate of exchange that was coming down in a strong and stable way. Take another example, the case of Chile. Some people say that Chile is also having a big decline in its real rate of exchange. But that is not true. If you take the basket of countries with which Chile is having trade, you will see that there are very small movements in terms of real rate of exchange, and that is why the Chilean situation is more stable than the Mexican or Argentinean situation."

Antonieta del Cid, Vice-President of the Central Bank of Guatemala, emphasised the need for harmonising macroeconomic policies.

"When the Latin American countries were discussing their access to NAFTA, the United States and Canada were very clear about the aspects of macroeconomic stability. That is why Chile, for instance, is the main candidate to enter into NAFTA. It is the most successful country in the Latin American region in macroeconomic stability in the last decade. And after the recent crisis of Mexico I think macroeconomic stability is going to be considered an even more fundamental issue than before. In the case of the Central American integration agreements there is no clear commitment to macroeconomic stability – it is just agreed 'to make the best effort'. But to make the best effort is not going to guarantee any success in terms of macroeconomic stability. In fact, we in the Central American countries have signed an agreement in October 1993, but last year Costa Rica and Honduras went into macroeconomic disequilibrium again. My point is that macroeconomic stability is a must. Of course, exchange rate arrangements are helpful. It is not the best way to do it, but at least they help to enforce some macroeconomic discipline among the countries."

Ricardo Ffrench-Davis, principal advisor on economic policy at ECLAC, suggested that macroeconomic stability and regional integration might be reinforcing each other. Ffrench-Davis elaborated on the question of whether integration would help to achieve macroeconomic stability.

"It depends on how you do integration," Ffrench-Davis said, "If you are integrating two parts and one part assumes that other countries will integrate to the macroeconomic activity of that part, that might imply macroeconomic instability for the second part. Only if integration is complete, then the two or three parts turn into one part in all senses: one currency, one political entity, one Minister of Health, one Minister of Social Security, and so on. In other circumstances – if you have only some parts integrating – integration might imply macroeconomic instability for some of the partners."

Roberto Bouzas, an Argentinean economist engaged in policy research, thought one should not place too much emphasis on the issue of macroeconomic stability as a precondition for integration.

"The problem is that we live in a second-best or third-best world and, at least in the South, macroeconomic instability is here to stay. It has returned recently in a very obvious manner in the Mexican case. So I think that placing the issue of macroeconomic stability as a precondition for integration is too strong a wording for the issue. Mercosur is a clear case in which a very large increase in trade has taken place in an environment of macroeconomic instability. Of course, probably the increase in trade and investment flows might have been larger in a more stable macroeconomic environment. But the fact is that this process took place in a context in which the largest partners, Brazil and Argentina, were going through serious macroeconomic instability. Why did this has happen? Well, the basic reason is that trade among many countries, and particularly among natural trade partners such as Argentina and Brazil, has been long repressed. So once you liberalise unilaterally on the one hand, and on the other hand you give preferences to the partner, the boom in trade is very large even when macroeconomic imbalances are there. So there is room to increase trade through preferential agreements even in the context of macroeconomic instability," Bouzas said.

Following up on the issue, Robert Devlin, chief of the Integration, Trade and Hemispheric Issues Division of the Inter-American Development Bank, stated that in Washington there is still a focus on macroeconomic conditions as a precondition for integration and accession in NAFTA. "I therefore think what Roberto Bouzas just said is very important. There are a lot of things you can do in integration even when there is disequilibrium in many areas of the macroeconomy."

Percy Mistry added that the recent turbulence in European exchange rates was an important example which showed that regionalisation does not lead automatically to stability.

"While in Europe everyone thought that the exchange rate mechanism would anchor stability, it in fact proved to be the opposite when there was a policy twist between the anchor country (Germany) and the others at entirely the wrong time. So you can't be axiomatic about it. In fact, the problem has just been repeated in Mexico. I don't think joining NAFTA helped, even though it was supposed to be a lock-in, to assure Mexican stability."

Regionalism, Multilateralism and Unilateralism

Hector Assael observed that Latin American countries have also embraced regional cooperation as a means to build a more safe base from which they can operate internationally. "Being inside such regional groupings, Latin American countries feel much more comfortable when they are opening up to the rest of the world. There is a kind of special agreement in terms that the openness with the rest of the world needs some kind of support from inside the region."

Robert Devlin added the argument that there is often a defensive component in regionalism vis-à-vis globalisation itself and vis-à-vis other countries or groups of countries.

"I think that is part of the US interest in regionalism. As a consequence, you have this problem of a maze of agreements which do not necessarily match, and can be a stumbling block. So you need some type of coordinating mechanism to have a common standard by which you can prevent regional integration agreements from becoming stumbling blocks to international trade. That is why the World Trade Organisation (WTO) and above all Article 24 are of increasing importance. Now there is a new understanding of Article 24 which presumably will enhance surveillance of preferential trade. This is important because today 50 or even 60 per cent of trade is preferential. Article 24 and the WTO are going to be very important to ensure that regionalism emerges in a way which is compatible with world growth, more trade and more cooperation. It really has to be in front stage if we want regionalism to be a building block instead of a stumbling block."

Percy Mistry agreed that regionalism may have an element of defensiveness, but he thought that this was largely a pre-Uruguay Round phenomenon which is now being moderated. "People are now beginning to walk away from the negative reasons for going regional and are looking much more at the positive reasons for going regional."

Mistry also agreed that coordinating mechanisms and surveillance at the multilateral level were critical. He thought that this would be an issue of concern not only for the World Trade Organisation (WTO) but also for the other multilateral economic organisations. "I think that the way in which the WTO interacts with the Fund and the World Bank and the regional development banks will be as critical if not more critical," Mistry said.

Ricardo Ffrench-Davis observed that since non-traditional exports are a target of regionalism they will tend to be a building block rather than a stumbling block to multilateralism.

"If regional cooperation is relevant for some sorts of commodities but there are other commodities that are very crucial in the traditional exports of member countries, one may have there an additional source of complemen-

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tarity or non-conflict between regional integration and integration into the global markets. I think that we should pay more attention to the fact that we are talking of different baskets of products when we are talking of trade with the world economy and trade with members of an integration group. Usually integration groups are trading in somewhat different sorts of commodities and that is tremendously significant in the case of Latin America."

Roberto Bouzas said there are usually two arguments made in favour of multilateralism. One is that multilateralism serves to balance the interests of consumers and exporting firms and workers against the interests of import-competing firms and workers. Second, multilateralism contributes to foster a cooperative environment among nations. Bouzas said he believed that the first argument – the balancing of interests – could be appropriately met by regionalism as long as the region was large enough. The second argument, however, could not be met adequately by a regional approach alone, he said.

"So I think this is a matter that becomes crucial, not in the debate about multilateralism or regionalism, which I don't think that any of us sees as a contradiction or as alternatives, but in the discussion about how to live with multilateralism and regionalism at the same time."

Bouzas further believed that the issues of convergence and inclusiveness raised by Percy Mistry in his paper should be taken as objectives or aims rather than as something which the integration process would naturally lead to.

"Why do I think convergence is not granted? Partly because regionalism does not foster a cooperative environment among nations globally, quite on the contrary. One of the main shortcomings of regionalism is precisely the increase in resentment which it may give rise to, not necessarily but it may give rise to. And the other reason is because when we speak about regionalism we are speaking about very different animals. For example, the European Union – which is very inclusive in terms of issues, ranging from the economic sphere to even the security matter – is very different from the US-Canada agreement which is purely trade. And as regards the inclusiveness issue, I would not take it for granted that inclusiveness is a feature of the present process of regionalisation. What the present process has shown, at least in the Western Hemisphere, is the difficulty of widening the regional agreements, and this creates a very serious political and policy problem for those who are left out of the agreement, particularly in an environment of uncertainty on how that agreement will be expanded in the future."

Shahen Abrahamian, officer-in-charge of the Global Interdependence Division at UNCTAD, thought that neither multilateralism nor regionalism had been the main force behind the liberalisation of trade.

"It seems to me that the main impetus is basically unilateralism," Abrahamian observed. "Not unilateralism in terms of imposing restrictions

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on your trade partner but a sort of voluntarily disarming on the trade side. This has been the main line that Latin America has followed. It is being driven by macroeconomic financial considerations. I think that the IMF and World Bank have had much more to do with the trade liberalisation of Latin America than the GATT."

Percy Mistry fully agreed with Abrahamian and added: "The new regionalism has only become possible in an ethos of unilateral trade liberalisation, and if that ethos had not occurred, then we wouldn't even be talking about the new regionalism. In fact we wouldn't even be talking about the potential for a new multilateralism. If that ethos had not existed, I think we would still be negotiating the Uruguay Round."

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Financial Flows for Regional Integration

Stephany Griffith-Jones with Patricia Canto and Mónica Ruiz

Much of the discussion on both regional and multilateral integration rightly focuses on trade aspects. However, also crucial in the integration process – especially regionally but also multilaterally – are its international financial aspects; even though crucial, these financial aspects tend to be insufficiently emphasised in many of the studies on integration, as well as in policy discussions of the subject.

There are at least three major aspects in which international financial flows and mechanisms play a very important role in regional integration.

1 Financial mechanisms are created explicitly with the purpose of enabling or facilitating trade integration. In the case of the Latin American and Caribbean (LAC) region, these mechanisms include, for example, the Latin American Integration Association (LAIA) payments and clearing arrangements, as well as the Banco Latinoamericano de Exportación (BLADEX). The relevant question that needs to be addressed is whether the mechanisms created operate efficiently and whether they are sufficient and on appropriate terms (e.g. maturities) to meet the needs of integration.

2 Regional integration can be more or less spontaneously stimulated by intra-regional direct investments. Such flows have played a particularly large role in the market-driven integration processes of Asia; they are also, however, playing a fairly important role in the move toward the policy-driven process of Western Hemisphere integration. Insufficient research and data compilation hinders full understanding of this phenomenon.

3 Last, but perhaps most importantly, regional integration leads to a process of increased investment from outside the region. This dynamic effect of investment creation for the country or region relates to the additional flows of foreign investment from outside the region generated by three factors linked to regional integration: (a) preferential and stable access to a significantly larger market; (b) potential regional complementarities in terms of resources and productive capacity; and (c) a decline in uncertainty on economic policies which countries will follow, called the "lock-in" or "candado" effect. (This latter effect has been especially highlighted

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in the context of Mexico's entry into NAFTA.)[1] Flows from outside the region have positive effects in terms of growth (especially clear in the short term), and hopefully on an increase in productive capacity in the medium term, but may have very problematic effects, in particular on overvaluation of the exchange rate, which may somewhat undermine a country's efforts at increasing exports, both within and outside the region.

This paper starts by describing, analysing and evaluating the financial mechanisms explicitly created to support regional integration within Latin America and the Caribbean. The next section of the paper examines the scale and composition of intra-regional investment flows in the LAC region and attempts to analyse their impact. We then briefly analyse the impact of regional integration on flows from outside the region, as well as their effects. Given the importance of NAFTA, special, but not exclusive, emphasis is placed on flows to Mexico. The final section discusses policy implications for Latin America and the Caribbean as well as for the Western Hemisphere.

I Financial Mechanisms Created to Support LAC Integration

Different schemes for collaboration in the financial and monetary field were created together with the initial regional agreements in the LAC region. These schemes have been mainly geared towards the creation of mechanisms that facilitate payments derived from transactions between countries in the region; some such schemes (and particularly the LAIA Clearing and Payment mechanism) have been modernised and revitalised to support the improved integration schemes better. To a lesser extent, and relatively more recent, are efforts to create schemes to finance exports, both within and outside the region.

Latin American Clearing and Payments Arrangements

The effectiveness of a payment and clearing system is based on several factors: (a) there must be a substantial demand for the use of the system for settlement of intra-regional trade; (b) there must be an effective system to minimise the arrears problem; and (c) the majority of member countries should not be in a permanent debtor-creditor position. In Latin America, the LAIA Reciprocal Payments and Credit Agreement is not just the only mechanism that fulfils these conditions, but it is also the only mechanism still performing payments arrangements in the region.

1 See, for example, J. Ros, "Beneficios comerciales y movilidad de capital: estudios recientes sobre las consecuencias de TLC", *Comercio Exterior*, México, Junio, 1994.

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Table 1 **LAIA Payments and Clearing Arrangements, and LAIA Imports 1966-93**
(millions of dollars)

Year	Anticipated Payments	Number of Central Banks Participating	Total Transactions (1)	LAIA Imports (2)	% (1/2) (3)	Net Settlement in Foreign Exchange	% (3/1)
1966	0	7	106	985	10.76	31	29.25
1967	0	7	333	1008	33.04	94	28.23
1968	0	9	392	1062	36.91	130	33.16
1969	0	10	482	1301	37.05	81	16.80
1970	15	11	560	1354	41.36	110	19.64
1971	24	11	695	1485	46.80	136	19.57
1972	9	11	979	1664	58.83	189	19.31
1973	10	12	1398	2312	60.47	281	20.10
1974	78	12	2276	3930	57.91	387	17.00
1975	3	12	2385	4006	59.54	662	27.76
1976	105	12	2923	4641	62.98	652	22.31
1977	170	12	3936	5793	67.94	887	22.54
1978	56	12	4457	5772	77.22	1135	25.47
1979	300	12	6421	8439	76.09	1630	25.39
1980	682	12	8643	10529	82.09	2021	23.38
1981	869	12	9331	12199	76.49	2554	27.37
1982	633	12	7770	10620	73.16	2245	28.89
1983	309	12	6371	7711	82.62	1809	28.39
1984	155	12	6776	8533	79.41	2052	30.28
1985	62	12	6726	7533	89.29	1499	22.29
1986	14	12	6673	7674	86.96	1066	15.97
1987	65	12	7492	8496	88.18	1269	16.94
1988	61	12	8753	9914	88.29	1458	16.66
1989	162	12	10137	11147	90.94	2513	24.79
1990	472	12	10020	12381	80.93	3469	34.62
1991	769	12	11610	15620	74.33	2866	24.69
1992	2347	12	13772	19960	69.00	3845	27.92
1993	3293	12	13176	n.a.*		3824	29.02

* Not available.
Source: Compiled by the authors, based on several LAIA publications and on UNCTAD, "Regionalisation and Integration into the World Economy: Latin American Experience in Trade, Monetary and Financial Cooperation", 31 Aug. 1994, Geneva.

Since 1986, the LAIA payments arrangement has been recovering from the debt crisis and the consequent financial squeeze of the 1980s.[2] As can be seen in Table 1, since 1986 both LAIA imports and the total transactions channelled through the clearing system have increased significantly (except for 1993, when the level of transactions channelled through the clearing system

2 For a good analysis of the mechanism's problems during the years of debt crisis, see ECLAC, "La cooperación regional en los campos financiero y monetario". In: *Serie Financiamiento del Desarrollo*, 5 December 1990, Santiago de Chile.

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fell fairly marginally). It is, however, interesting to note that the ratio of transactions through the clearing system to intra-LAIA imports has declined, from 91% in 1989 to 69% in 1992, as intra-LAIA imports grew faster than transactions going through the clearing system. The greater availability of foreign exchange, due mainly to the surge in private capital inflows in the early 1990s, would seem to be the main explanatory factor.

The Payments Agreement of LAIA which had been created in 1965 was modified in 1982; it has been signed by the Central Banks of Argentina, Bolivia, Brazil, Colombia, Chile, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela and the Dominican Republic. The system was designed to have three parts. Firstly, the Multilateral Payments Clearing Mechanism compensates multilaterally the trade operations. This compensation is done every four months, for all direct transactions between persons or companies resident in the countries of the region. On the due date of a transaction, the exporter has to be reimbursed by its commercial bank against presentation of valid documentation. The exporter's commercial bank then obtains reimbursement from his country's central bank, and the latter enters credit in favour and a debit to be charged to the importer's central bank, for whose account it has settled the amount due. At the end of each four-month period, "multilateralisation" takes place, as bilateral positions are assessed and cleared, resulting in a single debtor credit balance for each central bank, to be transferred or received as the case may be. The Central Bank of Peru and the Federal Bank of New York are the agent and common correspondent through which debit and credit balances are settled. The system is mandatory and thereby automatic in some countries like Chile, Ecuador, Mexico and Venezuela.

Secondly, LAIA also created reciprocal credit lines between their central banks, (at interest rates that approximate 90% of the daily average US "prime rate"), which are liquidated every four months. The LAIA Reciprocal Payments and Credit Agreement was amended in 1991, with the introduction of a two-tier Automatic Payments Programme for transitory financing of balances of multilateral compensation. The programme offers central banks automatic access to the credit or debit status of other central banks, as well as a short-term credit facility that extends the settlement period for central banks with difficulties in their liquidity position. This facility allows a delay in payment of debit balances of a central bank over an additional four-monthly period; this programme may be used, by the same central bank, as much as twice during two-year periods.

Thirdly, the LAIA Payments Agreement has a system of guarantees. The guarantees contemplated in the Agreement are those concerned with convertibility of national currencies into US dollars, transferability of the latter, and reimbursement and payment of operations processed. The

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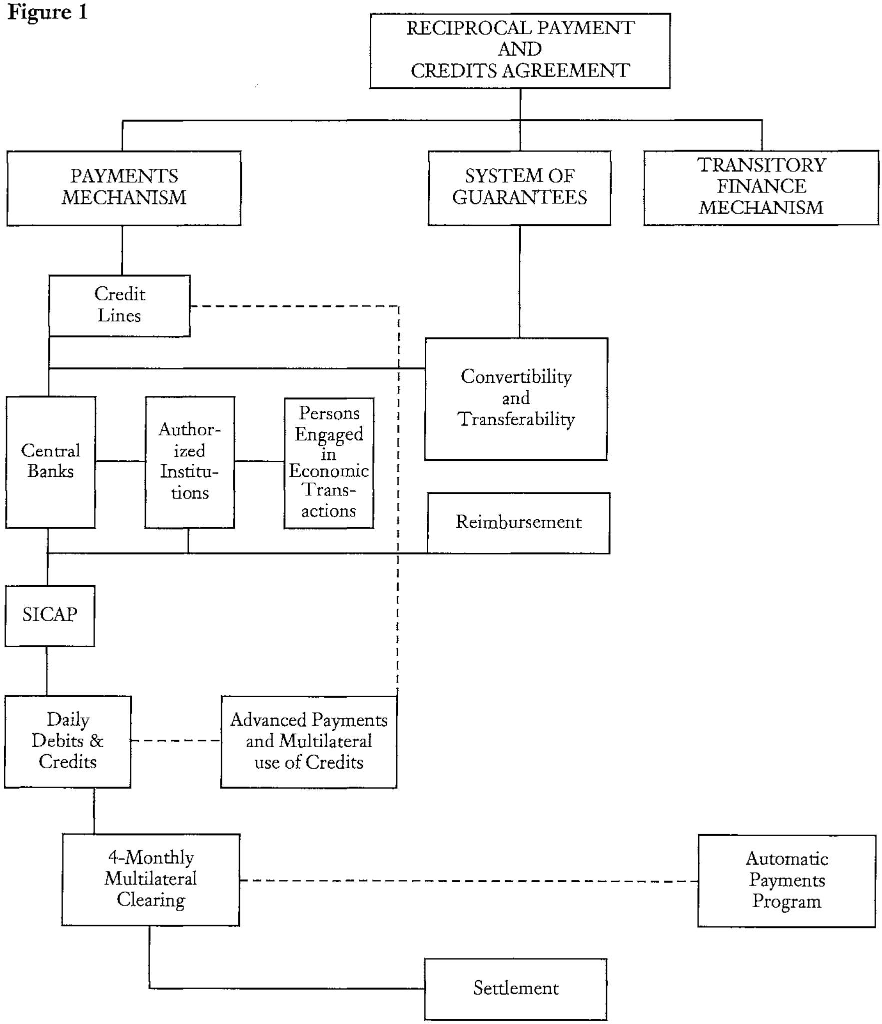
reimbursement guarantee is especially important because of the certainty it affords the exporter of timely collection of monies due, thus constituting a first supporting element of intra-regional trade[3] (the different elements in the LAIA Reciprocal Payment and Credit Agreement, as well as their inter-connections, can be seen in Figure 1).

Figure 1



3 For a clear detailed account, see LAIA, "Reciprocal Payments and Credits Agreements", January 1993.

Some recent modifications have reportedly[4] improved the operation of the LAIA payments system. To enlarge the scope of eligible transactions through the system, in 1991 LAIA authorised member countries to channel payments which originated from triangular trade; this allows the commercial bank of the exporter to anticipate the reception of funds and continue to offer financing to other customers; it also allows the commercial bank of a third member country to place available credit in a convenient manner. In 1993, transactions through this scheme amounted to only US$69 million.

An additional mechanism recently introduced by LAIA is the Financial Discounting of trade documents originated in transactions previously channelled through the system. The mechanism provides funding for exporters with the guarantee of the LAIA Payments Agreement. The estimated amount of transactions through this mechanism amounted to US$1.1 billion in 1993. It should be emphasised, that while some LAIA countries have incorporated this mechanism in their domestic rules, others (like Venezuela) explicitly forbid it or (like Chile) have suspended it.

As can be seen in Table 1, the significant volume of transactions of the LAIA Reciprocal Payments and Credit System is an important achievement. During the period of its functioning, the total transactions that went through the LAIA agreement reached a figure of US$155 billion; net settlements in foreign exchange reached US$39 billion. As a consequence, there was a saving of use of foreign exchange of approximately 75%.[5] This important saving of foreign currency clearly is beneficial, as it allows it to be used for other purposes, hopefully developmental ones. Amongst other benefits from the LAIA Payments Agreement are: (a) reduction of risk contingency and greater expediency on payments; (b) reduction of the cost of commercial transactions through the elimination of the traditional triangular banking process with institutions outside the region, plus eliminating the need for credit insurance on exports; (c) increased links between commercial banks as well as central banks of the region. The latter has facilitated the development of other financial integration mechanisms; and (d) the overall efficient operation of the guarantee mechanism has strengthened confidence in the regional commercial banking systems.

A final point relating to the LAIA Reciprocal Payments and Credit Agreement which is worth noting is that during the last few years there has been a growing tendency towards increasing anticipated payments, i.e. payments to be made before the compensation period finishes (see again

4 See, for example, UNCTAD, "Regionalisation and Integration into the World Economy: Latin American Experience in Trade, Monetary and Financial Cooperation", 31 Aug. 1994, Geneva.

5 Own estimates, based on Table 1 and LAIA data.

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mechanism. The failure in the 1980s of the latter two mechanisms seems to an important extent linked to the fact that in these, each country gave global credit lines without bilateral limits. In contrast, the LAIA mechanism was based on many bilateral credit agreements, which limited the maximum debtor position of one country with another; this prevented resources being concentrated in a few countries which then may be unable to pay back, disrupting the operation of the whole mechanism.

The main challenge now is either to revitalise the Central American and Caricom mechanisms, drawing on the lessons of their own experience and of the far more successful experience of the LAIA mechanism, or alternatively – which may become increasingly relevant in the medium term as regional integration hopefully broadens to include an ever growing number of countries in the region – to increasingly broaden the LAIA mechanism to include the Central American and Caribbean countries as well as others in the region.

Mechanisms for Intra-Regional Trade and Investment Financing

Latin American regional trade financing has traditionally been carried out by five main institutions: the Latin American Export Bank (BLADEX), the Central American Bank for Economic Integration (BCIE), the Andean Development Corporation (CAF), the Latin American Reserve Fund (LARF), and the Inter-American Development Bank (IDB). Of these institutions, BLADEX specialises solely in trade financing; the others also cover other fields, such as investment financing.

Latin American Export Bank

The Latin American Export Bank (BLADEX) started operating on January 1979, and has since maintained its headquarters in Panama City. The driving force behind the creation of BLADEX was the growing recognition among the Latin American governments of the need for the promotion and diversification of Latin American exports. BLADEX responded to the rationale that an active financial mechanism was needed in order to provide additional finance that matched the growing exports of manufactures and semi-finished goods that already had relevance in the total aggregate of Latin American production.

The creation of BLADEX was encouraged by the Inter-American Development Bank and supported by the World Bank's International Financial Corporation, which actually invested in the capital of the new institution. Today the Bank is constituted by five types of shareholders, as shown in Figure 2.

Figure 2 **BLADEX Type of Shareholders**

Class A	Class B	Class C	Class D	Class E
• Central banks • Banks with government majority capital • Other government institutions	• Latin American commercial banks • Financial institutions with a majority of Latin American capital	• Private and commercial banks • Financial institutions	• International organisations • International Finance Corporations	• Natural or legal persons

The Bank's main sources of funds are interbank deposits, borrowed funds and floating rate placements. In late 1994, the interbank deposits accounted for 50% of total financial liabilities. The other main sources of funding for the Bank are short-term and medium-term borrowings. The Bank provides short-term pre-export and post-export financing at competitive rates, mainly to shareholder banks for on-lending to exporters. It also finances imports originating within and outside the region, as long as they contribute to generate future Latin American exports.

The Bank is focused on short-term business, therefore its medium-term lending activities have had a modest growth since its establishment. Nevertheless, according to its 1993 report, there is increasing demand for the financing of exports of capital goods, which usually requires medium-term financing. The Bank has begun to raise medium-term funding (though still on a fairly small scale) with the intention of gradually increasing its medium-term lending. The management of the Bank believes that there are interesting business opportunities in the area of trade-related medium-term financing, which the Bank could pursue on a very selective and limited basis. Indeed, it would seem worth stressing that one of the main (if not the main) gaps in intra-Latin American financing is for medium-term lending, to support exports of capital goods and the development of infrastructure. BLADEX could play an important role here by expanding into this important area.

During 1993, the Bank's lending activities continued to achieve consistent growth, reflecting a strong demand for trade finance in all Latin American markets. Total loans grew by 35%, reaching over US$3 billion. This fact can largely be explained by the improving economic performance of most Latin American countries, coupled with free trade agreements. The distribution of the Bank's credit portfolio by country shows that Brazil, Mexico, Argentina, Chile and Colombia accounted for 86% of the total portfolio, reflecting the natural correlation to the size of these countries' economies and the volume of their total foreign trade (see Table 2).

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Table 2 **BLADEX Credits by Country**[a]
(thousands of dollars)

Country	1991	1992	1993
Argentina	251,497	288,070	408,026
Barbados	3,880	6,733	7,246
Bolivia	–	–	22,986
Brazil	492,222	649,297	960,682
Colombia	41,417	151,817	258,159
Costa Rica	21,345	20,972	27,935
Chile	129,691	219,567	185,458
Ecuador	15,600	30,656	38,449
El Salvador	1,233	20,275	13,077
Guatemala	2,850	8,786	24,871
Haiti	–	–	–
Honduras	4,375	5,294	2,665
Jamaica	36,643	17,376	15,242
Mexico	507,886	620,015	852,446
Nicaragua	6,613	12,878	1,650
Panama	6,283	13,703	10,424
Paraguay	2,211	350	2,348
Peru	82,394	91,329	89,249
Dominican Republic	29,518	56,990	94,648
Trinidad and Tobago	311	5,792	10,000
Uruguay	2,751	34,125	12,892
Venezuela	13,271	70,611	46,129
Others	1,200	6,800	4,594
Total	**1,653,191**	**2,330,936**	**3,089,176**

[a] Includes loans, letters of credit and acceptances.
Source: BLADEX, Annual Report, 1993, p. 24.

Central American Bank for Economic Integration

The Central American Bank for Economic Integration (BCIE) finances investment projects, especially sub-regional infrastructure programmes, and funds projects that create economic complementarity and expand intra-regional trade.

The scale of its lending has been relatively modest, as from its inception in 1961 until the end of 1992, the Bank has lent a mere US$1.7 billion. Recently, the Bank's financial situation was strengthened thanks to external support (the Bank will benefit from recent international initiatives to support the Central American sub-region, particularly from the European Union and the IDB), and to the inclusion of two new extra-regional partners, China and Venezuela.

Andean Development Corporation

The Andean Development Corporation (CAF) has provided support to the Andean region. It grants medium-term and long-term credits for investment and pre-investment projects; it finances non-traditional exports among the Andean countries and towards other countries; it also facilitates imports from third countries into the Andean region, whereby the CAF assures the risk taken by the bank, via the Mechanism for Confirmation of and Financing of Letters of Credit and Imports (MECOFIN). In 1993, reportedly the institution committed loans of US$2.1 billion.[7] In the same year CAF launched its programme of share participation in private enterprises of member countries and the guaranteeing of bond issues. Thus CAF seems to be adapting flexibly to countries' new needs and to changes in the international financial environment.

Latin American Reserve Fund

The Latin American Reserve Fund (LARF), available to all LAIA member countries, was created in March 1991, on the base of the Andean Reserve Fund, which had operated since 1978.

The main objective is to provide balance of payments credits for the financing of member countries' adjustment policies. For this purpose, total financial support amounting to US$3.7 billion was extended over the 1978-91 period, with the largest part (US$2.1 billion) granted in the form of six-monthly short-term credits and the rest (US$1.6) going to medium-term balance of payments credit support. The main benefit that member countries obtain from the LARF seems to be that it grants member countries rapid access to credit at levels well above individual contributions. The main source of LARF's resources is its own assets and deposits made by member countries' central banks; this distinguishes it from CAF, which funds itself mainly on the international financial markets.

In addition, in 1992, the institution established a facility which offers credit lines that can be used by commercial banks for export financing to member countries. This, together with the Discounting of Banking Acceptances, – through financing intermediaries – allows the LARF to support trade finance operations, both within the sub-region and also with non-LARF member countries.

Another important function that LARF performs is to provide an attractive alternative for countries to invest their reserves. As ECLAC, op. cit., shows,

7 See UNCTAD, op. cit.

in most years the yield in assets invested in this institution was significantly higher than in US Treasury Bills.

Inter-American Development Bank

The Inter-American Development Bank (IDB) is a major financing institution in the region. Its total lending in recent years has been almost as high as World Bank lending to the LAC region.[8] To the extent that a fairly important proportion of its loans go to fund infrastructure, it has very directly supported both regional integration and integration with the world economy. In the field of trade finance, the IDB has approved 43 export financing loans of a cumulative total portfolio of US$1.6 billion; these were granted both from the Bank's ordinary resources and from the Venezuelan Trust Fund. The IDB has recently launched a "Proposal for the establishment of a Regional Network of Export Credit Rediscount Facilities", to provide pre-shipment and post-shipment export financing for the short, medium and long term. Besides its fairly limited role in funding trade, the IDB will play an important role in supporting the regional integration process. An obvious key area is the financing of inter-national transport and communications networks, with special emphasis on investment in the connection between networks existing at a national level.

To conclude this section on mechanisms for intra-regional trade and investment financing, it seems worth stressing that the different institutions that fund trade and investment within the region have on the whole performed fairly well, meeting important needs, and have adapted rather well to changes in those needs.

However, two caveats need to be made. First, there are important gaps in the provision of trade credit. Perhaps the largest gap is insufficient medium-term financing to fund exports of capital goods, both within the region and outside it,[9] as well as to fund large inter-regional infrastructure projects. As regards the latter, given its important expertise in the area, the IDB should clearly play a key role, where possible supplemented by private capital. As regards the funding of exports of capital goods, it would seem important to define what institutions at a regional level should take a lead in this important area, as well as to what extent such funding would be most efficiently provided by one or several regional institutions, and/or by national export credit agencies, as occurs in all developed countries, and as exist in the region

8 For more details, see, for example, S. Griffith-Jones et al. "An Evaluation of IDB Lending 1979-1992", IDS Research Report, Sussex, 1994.

9 Interview material.

for Mexico and Argentina. (Because the experience of Bancomext is so interesting in this context, we include a brief description of its operations and functions in Annex 1.) Indeed, the provision – at a country and/or regional level – of sufficient credit and/or credit guarantee, especially of a medium-term and long-term nature, seems currently an important gap in the financing of trade in LAC countries.[10] Similarly, there seems to be insufficient credit for financing of exports by small and medium enterprises. In this context, the creation of agile and appropriate mechanisms for funding non-traditional exports could represent a large potential for the region, and especially exercise an important effect on intra-regional exports.

A second caveat is that the number of institutions providing finance for trade in the region is fairly large, and seems to have some overlapping of functions. Particularly when and if trade integration progresses towards a truly regional or hemispheric scale, some streamlining of institutions that finance trade within the region may be desirable. However, such streamlining should be carefully carried out, so that no important functions or country links are cancelled, unless it is clear that they will be adequately performed amongst the remaining public or private institutions.

II Intra-Regional Foreign Investment Flows

An important distinction made in the literature on economic regionalism is that between market-driven (or de facto) versus policy-driven (or de jure) regionalism.[11] The classic example of policy-driven regionalism is European integration, while the main example of market-driven regional integration is the Asian experience. Within this latter process, intra-regional foreign direct investment (FDI) has played a key role in supporting both rapid economic growth in that region and stimulating rapidly growing intra-regional trade. Indeed, while in the 1980s 70% of investment flows from underdeveloped countries were channelled to the developed world, the majority of Asian FDI flows went to developing countries in Asia, mainly for investment in export-oriented manufacturing.[12]

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10 Interview material; see also, CEPAL, "El regionalismo abierto en América Latina y el Caribe", Santiago de Chile, 1994.

11 See P. S. Mistry "Regional Integration and Development: Panacea or Pitfall?" FONDAD, 1996. World Bank, "The New Regionalism and its Consequences", March 1994, mimeo, International Economics Department. C. Oman, *Globalisation and Regionalisation: The Challenge for Developing Countries*, OECD, Paris, 1994.

12 See W. Peres, "The internationalisation of Latin American industrial firms", In: *CEPAL Review 49*, April 1993, Santiago de Chile. P.E. Tolentino, *Technological Innovation and Third World Multinationals*, Routledge, London, 1993.

The Latin American and Caribbean regions seem to be in an intermediate position. Though to an important extent integration within the LAC region and with the US is policy-driven, there is emerging an increasingly dynamic undercurrent of largely de facto or market-driven investment flows which encourage integration. As the growth of these intra-regional investments is a new phenomenon, information on them is still quite patchy; efforts at analysing their impact are even more rudimentary. In what follows, we will attempt to systematise the data, emphasise certain peculiarities of this phenomenon, and provide a framework for analysing its impact.

It is only recently that Latin America and the Caribbean have seen outward FDI increase, despite the fact that the first outward Third World investment originated in the region; thus, amongst the first developing countries' TNCs on record was an Argentinean textile manufacturer, Alparagatas, and a food manufacturer, Bunge y Born. These investments were channelled to other South American countries, especially Brazil.

Table 3 FDI Outflows, annual averages
(millions of dollars)

Country / Territory	1975-77	1978-80	1981-83	1984-86	1987-89	1990-91
LAIA	**169.0**	**686.5**	**272.5**	**276.3**	**392.7**	**605.1**
Argentina	-0.3	-192.0	-45.0	–	–	–
Bolivia	–	0.5	0.1	–	1.5	1.6
Brazil	147.0	687.0	256.7	88.7	278.7	332.5
Chile	1.7	15.0	–	–	–	–
Colombia	12.3	171.0	56.7	20.7	33.0	20.0
Paraguay	8.3	5.0	–	–	–	–
Uruguay	–	–	2.7	3.0	-0.9	–
Venezuela	–	–	1.3	164.0	80.3	251.0
Central America	**-0.4**	**7.2**	**3.7**	**4.1**	**3.8**	**3.3**
Costa Rica	-0.4	7.2	3.7	4.1	3.8	3.3
Caribbean	**1.4**	**8.1**	**3.0**	**8.3**	**4.0**	**1.4**
Barbados	0.7	0.8	1.0	2.1	2.1	1.4
Netherlands Antilles	0.7	7.3	0.7	-0.2	2.5	–
Trinidad & Tobago	–	–	1.2	6.3	-0.6	–
Total	**170.0**	**701.8**	**279.2**	**288.7**	**400.4**	**609.7**

Source: UNCTAD, Division on Transnational Corporations and Investment, "World Investment Directory, Vol. IV: Latin America and the Caribbean", New York, 1994.

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According to UNCTAD data (see Table 3), average annual outflows of FDI from countries in the LAC region (excluding Mexico) reached US$610 million in the 1990-91 period, a level almost four times higher than during the 1975-77 period. After the decline of outflows in the early eighties, there was strong growth in annual average FDI outflows from countries in the region between 1984-86 and 1987-89, with further increases occurring in the 1990-91 period. Though data available from other sources indicate somewhat higher outflows, the trends shown in Table 3 are the same as those given in other sources. The key point is that a recovery of growth in the region, the prospects of increased integration, the opportunities offered by privatisation and greater availability of foreign exchange (due mainly to a massive surge in capital flows from abroad) have increased the propensity to invest abroad in the early 1990s of the countries in the region.

As can be seen in Table 3, it is the member countries of the LAIA, the relatively most industrialised countries of the region, which are practically the only source of outward FDI from the region, representing around 99% during 1987-91.

Latin America's outward direct investments tend to be heavily concentrated in certain destinations. For Brazil, Mexico and Venezuela the main recipient country is the United States; Colombian, Chilean, Argentinean and Peruvian outward investments are directed primarily to other Latin American countries.[13] Particularly in the case of Chile there has been very rapid growth of outward FDI in the early 1990s, concentrated in the acquisition of important assets in the privatisation of companies, especially in Argentina and Peru (see Table 4). Mexico has become a dominant source of FDI in the Central American region (especially Guatemala). Brazil, as well as more recently Argentina, is a significant source of FDI in Paraguay and a number of the Mercosur countries. Venezuela and Colombia have also become an important source of FDI for a number of smaller countries in the Andean Pact. The cases of Mercosur and the Andean Pact just mentioned would seem to show the significance of intra-regional investment following de jure integration. On the other hand, the Chilean outward investment mentioned above, which was largely concentrated in Argentina, preceded any major increase in formal integration between the two countries.

Reportedly, the early 1990s have been characterised by a further increase in outward FDI, and an increase in the share of such investments undertaken in other LAC countries.[14]

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13 Data from Peres, op. cit. and Table 4.

14 UNCTAD, "World Investment Report: Transnational Corporations, Employment and the Workplace", UNCTAD, Geneva, 1994.

Table 4 **Geographical Distribution of Outward FDI Stock, by home country** (percentage)

Home Country / Year	**All Developed**	**North America**	**Western Europe**	**Other Developed**	**All Developing**	**LAC**
Brazil (1990)	54.1	36.4	17.2	0.4	45.9	44.1
Chile (1992)	6.2	0.7	5.1	0.4	93.8	80.9
Colombia (1990)	24.6	20.7	3.9	-	75.4	71.6
Peru (1990)	20.0	100.0	-	-	80.0	74.0

Source: UNCTAD, Division on Transnational Corporations and Investment, "World Investment Directory, Vol. IV: Latin American and the Caribbean", New York, 1994.

Latin American outward FDI tends to be fairly heavily concentrated in the secondary and tertiary sectors, with a fairly important concentration in certain sub-sectors. Over 95% of Venezuela's investment in the US is in petroleum refining and related industries. Mexican investment is heavily concentrated in non-metallic minerals industries, mainly in glass (Vitro) and cement (CEMEX). Brazilian investment is heavily concentrated in the production of cars, clothing and marketing.

The scale and motivation of some of these investments can be illustrated by the case of the two major Mexican investments abroad, which mostly were undertaken through the acquisition of existing firms. The most important take-over of a US firm by a Mexican conglomerate was by Vitro, which in 1989 bought the second largest glass container manufacturer in the United States. The cost of the acquisition was estimated at over US$900 million. Reportedly the main motivation was the need to guarantee its international expansion.[15] The Mexican cement conglomerate CEMEX first took over its major domestic competitor to prevent its being acquired by one of the largest world producers, and then went abroad. The argument given to justify such a strategy was to increase cost-efficiency through economics of multi-plant operations and improvement of distribution channels. CEMEX purchases abroad included not only a major plant in the US, but also the two largest Spanish cement producers. After its investments in the 1990s (estimated at US$1.8 billion) CEMEX became the fourth largest cement producer in the world. The scale of these firms' investments shows that they are following strategies whose main elements for defining the structure of their industries and their competitive positions are determined in the integrated Mexican-US economic area. As a result of this broadened regional – and in some cases

15 A. Calderón, M. Mortimore and W. Peres, "Mexico's Integration into the North American Economy: the Role of Foreign Investment", In: IRELA, *Foreign Direct Investment in Developing Countries: the Case of Latin America*, Madrid, 1994.

global – perspective, these Mexican firms are becoming major international players in their sectors.

For the most advanced economies in the region, the late 1980s and early 1990s have seen increasing outward FDI in the tertiary sector, particularly in banking and financial services, as well as wholesale and retail trade. These outflows have been directed to less industrialised countries within the region, stimulated by regional economic integration and the removal of FDI barriers. The tertiary sector has been dominant in the outward FDI of Colombia and Peru. The tertiary sector has also dominated outward FDI of Chile, most recently with privatisation opportunities within the region enabling Chilean firms to expand their investment in utilities.

More generally, one of the main factors that has encouraged an important surge in intra-regional investment is the privatisation of state companies. Outstanding examples were the purchase of 80% of the Argentinean company SOMISA by a consortium consisting of the Argentinean group TECHNIT, the Chilean company CAP, and the Brazilian SIMINAUS and VALE DO RIO DOCE. Another important example was the sale of Quellaveco copper deposits in Peru for a small amount to the Chilean company MANTOS BLANCOS, which has promised to invest more than US$500 million.

Chilean Investment

Reportedly, Chile has in recent years become the most active Latin American country undertaking FDI in the region. By October 1994, the stock of Chilean FDI in the region amounted to more than US$1.1 billion, of which almost US$700 million (over 60%) was in Argentina; indeed, in Argentina, there are more than 50 companies owned by or linked to Chilean corporations. A large part of this stock was acquired in 1992 through participation in the Argentinean privatisation programme. The Argentinean Economic Ministry reports that 60% of the sales of public companies were to foreign investors; Chilean investors played an important role in this process, accounting for 6 per cent of total sales. The most significant sectors for Chilean investment in Argentina are electricity and gas; recently, Chilean investors have also acquired an important share in the privatised electrical companies of Peru; as a result, Chilectra has become the largest company in Latin America for distributing electricity. Also significant in Chilean investment in Argentina, as well as in other neighbouring countries, are the privatised pension fund administration companies.[16]

16 *El Mercurio, Edición Internacional*, 17-23 Nov. 1994, Santiago de Chile. These figures are based on Central Bank data; other estimates are far higher. For more details, see: A. Calderón and S. Griffith-Jones "Los flujos de capital extranjero en la economía chilena: renovado acceso y nuevos usos", mimeo, CEPAL, 1994.

A very interesting feature in the process of outward regional investment by Chilean companies (which may well be relevant for the case of other Latin American companies) is that this outward regional investment is to an important extent funded by resources obtained on the international capital markets, and especially those obtained by placement of Chilean shares on the New York stock exchange, via American Depositary Receipts (ADRs).[17] Furthermore, it would seem that an important part of the financial resources obtained by Chilean companies via ADRs and also via other mechanisms, such as international loans, have been dedicated to – and were obtained specifically with the purpose of – the financing of their outward regional FDI, especially in investments in privatisations in Argentina and Peru. It could indeed be argued that on a fairly limited scale Chile becomes a "recycling centre" for financial resources, which come from the international capital markets (especially the US ones) and are then channelled towards Chilean outward regional investment. On a small scale, it could be said that Chile has become a regional financial centre.

A second important feature of much Chilean outward foreign investment to the region (which may also be important for other countries) is that outward investment often seems to be associated with export of "know-how" in management and technical aspects, to an important (though not exclusive) extent linked to the fact that economic reforms began significantly earlier in Chile[18] than in neighbouring countries, and to the fact that the economic reforms (in aspects such as privatisation) follow very similar patterns to, and are to a certain extent modelled on, those carried out earlier in Chile. This is particularly clear in the case of the electricity and gas sector, as well as that of private pension fund administration companies, because in these cases privatisation in Chile had occurred in the 1980s, which has allowed an important period of experience.

It is the link between these three aspects – the renewed access on an important scale to international capital markets in the early 1990s of Chilean companies, the expertise previously acquired by Chilean companies related, to a fairly important extent, to early privatisation, and finally the opportunities offered by the recent processes of privatisation in neighbouring countries – which provided important incentives for the rapid growth of Chilean regional outward FDI. The liberalisation by the Chilean Central Bank in 1991 of the mechanisms through which outward investment could be carried out significantly facilitated the process. It is interesting that this liberalisation was to a great extent spurred by an important increase in

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17 See A. Calderón and S. Griffith-Jones, op. cit., especially Table 8, and case studies.

18 Interview material.

foreign reserves, also linked to the beginning of the surge of capital flows to Chile, as well as to several other Latin American countries.[19] Thus, both at a microeconomic and at a macroeconomic level, the increase in Chilean outward investment, mainly in the region, is related to, and to a certain extent underpinned by, the surge of flows from global capital markets. Here the processes of globalisation and regionalisation clearly complement each other.

Balance of Payments Impact

An important issue, still insufficiently explored, is the extent to which Latin American firms' foreign investment activity affects and will affect in the medium term the home country's balance of payments, and ultimately the welfare of its population.

There is as yet insufficient information available to allow such an evaluation for intra-Latin American investments. However, a first rough evaluation can be made of the balance of payments impact of Latin American FDI in the US. Indeed, as can be seen in Table 5, for each of the years 1988-1992, the impact of Latin American foreign affiliates in the US on the trade balance of the US was negative. Although this does not mean that the source country is the sole beneficiary, this information added to that of available studies[20] would seem to indicate in a preliminary way that Latin American foreign investments in the US contributed to improve those countries' trade balance. A fuller understanding of the balance of payments impact of such FDI would, however, need to examine flows on the capital account (including capital flows and profit remittances) as well. Indeed, a word of caution may be important here. A recent study by the Federal Reserve Bank of New York[21] suggests that US companies recently purchased by foreign capital have on average had losses.

III The Surge of Private Flows into the Region and the Link with Regional Integration

As is well known, there has been a major surge in private capital flows into the LAC region[22] in the 1990s. An important proportion of these flows came into Mexico (see Table 6).

19 See, for example, S. Griffith-Jones et al., "The Return of Private Capital to Latin America", In: J.J. Teunissen (ed.), *Fragile Finance: Rethinking the International Monetary System*, Fondad, The Hague, 1993.

20 Quoted in Peres, op. cit.

21 *Financial Times*, November 5, 1994.

22 See R. Ffrench-Davis and S. Griffith-Jones (eds.) *Coping with Capital Surges: the Return of Finance to Latin America*, Lynne Rienner and FCE, Boulder, 1995.

From: Regionalism and the Global Economy: The Case of Latin America and the Caribbean
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Table 5 United States: External Trade of Non-Bank US Affiliates of Foreign Firms (millions of dollars)

Source Country	1988 Exports from US	1988 Imports from US	1989 Exports from US	1989 Imports from US	1990 Exports from US	1990 Imports from US	1991 Exports from US	1991 Imports from US	1992 Exports from US	1992 Imports from US
Brazil	148	186	134	186	196	211	216	551	483	811
Mexico	84	803	131	821	157	811	125	904	377	883
Venezuela	74	n.a.*	141	2,886	257	4,637	n.a.*	n.a.*	n.a.*	n.a.*
Other	1,217	n.a.*	1,274	609	1,027	603	n.a.*	n.a.*	n.a.*	n.a.*
Latin America Subtotal	**1,542**	**3,806**	**1,681**	**4,501**	**1,637**	**6,262**	**1,698**	**5,666**	**2,397**	**6,054**
Panama	266	523	331	544	247	547	280	181	602	140
Latin America Total	**1,808**	**4,329**	**2,012**	**5,045**	**1,883**	**6,809**	**1,978**	**5,847**	**2,999**	**6,194**
World Total	**69,541**	**155,533**	**84,263**	**169,745**	**91,137**	**180,647**	**96,933**	**178,702**	**100,615**	**182,152**

* Not available, suppressed to avoid disclosure of data of individual companies.
Source: United States Department of Commerce, "Survey of Current Business", several numbers.

Table 6 Net Capital Flows to Latin America[a] (billions of dollars and percentage)

	Total Net Flows						Percentage of GDP					
	1977-81	1983-90	1990	1991	1992*b*	1993*b*	1977-81	1983-90	1990	1991	1992*b*	1993*b*
Latin America and the Caribbean	29.4	10.1	21.6	37.0	59.4	64.2	4.5	1.3	2.0	3.2	4.7	4.7
Argentina	1.9	1.8	1.5	3.0	10.9	10.0	2.0	2.3	1.1	1.6	4.9	4.1
Chile	2.6	1.5	3.1	1.4	3.5	2.8	12.7	7.0	10.3	4.2	8.6	6.3
Mexico	8.2	0.8	11.6	21.9	24.7	28.5	5.1	0.3	4.8	7.6	7.5	8.3

a Includes long and short-term capital, unrequited official transfers and errors and omissions.
b Preliminary figures.
Source: ECLAC, "Policies to improve linkages with the global economy. Report for the XXV sessions' period", Chapter IX, Santiago de Chile, 1994.

A number of reasons, both domestic and international, explain this surge of capital flows to the LAC region. These include, on the international side, very low US interest rates and recession in the industrial countries in the early 1990s, and changes in US capital market regulations. On the domestic side, they include far greater macroeconomic stability, the elimination of the debt overhang via Brady deals and other mechanisms, as well as profitable opportunities provided by the development of domestic capital markets, privatisation programmes and relatively high real interest rates.

Clearly the prospects of regional integration, and especially integration into NAFTA, have been an important factor encouraging such inflows, particularly into Mexico. This seems to be particularly the case for foreign direct investment flows. Indeed, shorter term profitability factors are the key to the very rapid growth of portfolio flows to the LAC region in general, and to Mexico in particular, even though the prospect of "locking" structural reforms and macroeconomic stability via NAFTA reduces perceived country risk for Mexico, and therefore also contributes to increase its attractiveness for portfolio flows; so does the signing of memoranda of understanding and co-ordination of efforts with US regulators, efforts facilitated by the prospects and reality of NAFTA. However, it is FDI flows which would seem to respond more strongly to longer-term considerations; in this context, Mexico's entry into NAFTA provides a more reliable access to the huge North American market. Reportedly, the rules of origin and local content negotiated within NAFTA afford enough flexibility to enable the participation of investors from all over the world.[23] This was largely because the opinions of companies already operating in Mexico, especially automobile companies, prevailed in the discussions. Indeed, though foreign direct investment in Mexico by US and other multinational companies was already important before NAFTA (de facto integration), NAFTA increased Mexico's appeal to investors of diverse origins as a platform for exporting manufactured goods, particularly to the North American market. Volkswagen and Nissan have taken important decisions in this regard; it is expected that increased integration could also lead some North American subsidiaries in Asia to transfer their operations to Mexico.

Table 7 shows how significantly FDI to Mexico has increased since NAFTA was announced and approved. Total FDI grew from US$1.7 billion in 1988 to US$2.6 billion in 1990, and reached US$4.9 billion in 1993, with a further important increase reported for 1994. (It should be mentioned that in the early 1980s there was also a surge of FDI, with inflows averaging around

23 See A. Gurría "Capital Flows: the Mexican Case", In: R. Ffrench-Davis and S. Griffith-Jones, op. cit.

US$3 billion in 1980-81; this surge, however, was brief and was then dampened by the debt crisis.)[24]

Table 7 **Mexico: Foreign Investment Flows**
(millions of dollars)

	1990	1991	1992	1993
Total New Foreign Investment	**6,004**	**17,504**	**22,404**	**33,332**
Direct Investment	**2,633**	**4,761**	**4,393**	**4,901**
New Investment	1,115	3,422	3,012	4,108
Re-Investment	1,070	1,408	1,020	1,135
Inter-Company Accounts	448	-69	360	-342
Portfolio Investment	**3,371**	**12,743**	**18,011**	**28,431**
Stock Market	1,995	6,332	4,783	10,717
Securities denominated in new pesos	–	3,396	8,117	6,868
Securities denominated in foreign currencies	1,376	3,015	5,111	10,847

Source: Personal elaboration based on information from the Banco de México.

Table 7 also shows the spectacular rise in portfolio investment flows during the 1988-93 period from 0 to US$28 billion (even though these fell very significantly in 1994). As pointed out above, portfolio flows respond mainly to short-term factors, and may be extremely volatile. However, NAFTA may have encouraged the surge of foreign investment in the Mexican stock market in 1993. Nevertheless, the fact that portfolio flows fell in 1994, precisely the year when NAFTA started, would seem to show the somewhat tenuous link between portfolio flows and NAFTA. It could be argued that the fall in portfolio flows in early 1994 could have been far sharper without the existence of NAFTA and the mechanisms it creates. Indeed, when fairly major outflows of portfolio flows were threatening in April 1994 to lead to an important devaluation of the Mexican peso, the US, Canada and Mexico reached an agreement to establish an exchange stabilisation fund of US$8.8 billion. This mechanism was, however, unable to prevent a dramatic outflow and major devaluation in December 1994, when portfolio capital left Mexico on a very large scale.

As regards FDI to Mexico, Table 8 shows its composition by country of origin. There is as yet no clear pattern emerging here of the impact of NAFTA. Indeed, the share of FDI originating in the US first fell sharply in

24 Data based on Gurría, op. cit.

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1992, only to rise sharply in 1993; the share of FDI from Japan has fallen quite consistently in recent years. Flows from Canada seem to have a relatively constant share. Trends for the share of European flows are a bit unclear, with British investment apparently increasing. Overall, we see an increase (in absolute values) from practically all countries, with the exception of Japan.

We can therefore conclude that Mexico's entering into NAFTA has so far been associated with a fairly important increase in FDI and that a causal link seems important; it is also – very weakly – associated with a surge of portfolio flows, but the causal links are less clear.

Table 8 New Foreign Direct Investment in Mexico by Country of Origin
(millions of dollars)

Country	1990	%	1991	%	1992	%	1993	%
United States	2,308.0	62.0	2,386.0	66.9	1,651.7	45.1	3,503.6	71.5
United Kingdom	114.4	3.0	74.1	2.0	426.8	11.8	189.2	3.8
Germany	288.0	7.7	84.6	2.3	84.9	2.3	111.4	2.2
Switzerland	148.0	3.9	68.0	1.9	315.2	8.7	101.7	2.0
Japan	120.8	3.2	73.5	2.0	86.9	2.4	73.6	1.5
France	181.0	4.8	500.5	14.0	68.9	1.9	76.9	1.5
Spain	10.8	0.2	43.5	1.2	37.2	1.0	63.5	1.2
Canada	56.1	1.5	74.2	2.0	88.4	2.4	74.2	1.5
Sweden	13.3	0.3	13.8	0.3	2.0	0.1	2.4	0.1
Italy	4.6	0.1	1.9	0.1	7.5	0.2	4.6	0.1
Others	477.2	12.8	244.8	6.8	830.1	23.0	699.6	14.0
Total	**3,722.2**	**100.0**	**3,564.9**	**100.0**	**3,599.6**	**100.0**	**4,900.7**	**100.0**

Note: Excludes portfolio investment and the amount of foreign capital that resulted from authorisations granted by the CNIE to invest in companies traded on the Mexican Stock Exchange. Figures may not add up because of rounding.
Source: Personal elaboration based on information from the Banco de México.

The link between integration with a major market and increased FDI seems also to be shown by other experiences. As Table 9 shows, after Portugal and Spain joined the EC, FDI to those countries increased very significantly, apparently showing the close link between increased FDI and regional integration with a very important market. However, it should be stressed that participation in a regional market is not a sufficient condition for a developing country to attract FDI. As Table 9 shows, after Greece joined the EC, it did not experience a large increase in FDI inflows. However, the southern enlargement of the EC does show on balance a net important positive effect of integration on FDI flows.

Indeed, in the case of Mexico, and also in the case of a possible accession of Chile to NAFTA, it seems clear that the main benefits of joining NAFTA for the Latin American economies are not obtained via effects from trade,[25] but via effects from increased capital flows. Thus models prepared to measure such impacts of NAFTA for the Mexican economy estimate fairly small effects (of around 2.0 to 3.0% of Mexican GDP) for trade creation, which include both the classic effects via inter-sectoral reallocation of resources to sectors with comparative advantage and the benefits resulting from economies of scale and increasing returns to scale. Once estimates for additional higher foreign investment are added, the total impact of NAFTA increases fairly significantly, with estimates reaching a range of 5.0 to 8.0% of GDP.[26] The key problem with measuring precisely the effect of additional FDI flows is the uncertainty about their magnitude.

Table 9 **Average FDI Flows and Rates of Capital Formation in Selected Countries**
(percentage)

	1976-80	1981-85	1986-91
Greece (1981)*			
FDI inflows/gross domestic capital formation	5.4	6.0	8.0
FDI inflows/GDP	1.5	1.3	1.5
Portugal (1986)*			
FDI inflows/gross domestic capital formation	1.5	3.0	10.7
FDI inflows/GDP	0.4	0.9	3.0
Spain (1986)*			
FDI inflows/gross domestic capital formation	2.8	5.3	9.2
FDI inflows/GDP	0.7	1.1	2.2

* Years in parenthesis reflect date of joining EC.
Source: Based on "World Investment Report", United Nations, New York, 1993.

A final point needs to be made here. Additional FDI and other capital flows, linked to regional integration, have important economic benefits, both of a macroeconomic kind (by providing foreign exchange that allows higher growth) and a microeconomic kind (by facilitating improvement of technology and management). However, there are also risks in capital flows, especially clear in non-FDI flows. Thus, surges in capital flows can – and recently have – led to overvaluation of currencies, which discourages exports,

25 See Ros, op. cit.
26 See for example D. Brown, A. Deardorff and R. Stern, "A North American Free Trade Agreement: Analytical Issues and a Computational Assessment", mimeo, 1991.

even though increased exports are precisely a key aim of regional integration. Increased capital inflows may also partly replace domestic savings, and therefore lead only partly to increased investment. If insufficient capital inflows are channelled into increased investment in tradeables, the country could be creating balance of payments problems for the future. If an important proportion of inflows is devoted to increased investment in tradeables (more likely in the case of FDI), their long-term effects are more likely to be beneficial. Above all, as recent events in Mexico have shown, portfolio and short-term capital flows can be incredibly volatile, with very negative effects on countries' economies.

We therefore can conclude that the main welfare effects of regional integration (and especially of NAFTA) are related to the impact of increased foreign inflows. Though there is evidence of such an impact, its magnitude is somewhat unclear, as are its long-term effects. However, as regards the latter, cautious optimism seems justified by preliminary evidence, though euphoric conclusions clearly are not. Unfortunately, events in Mexico in December 1994 confirm many of the concerns of more pessimistic analysts.

IV Conclusions and Policy Issues

Financial mechanisms and flows play a key role in supporting economic integration. In the case of Latin American and Caribbean integration, a number of institutions were explicitly created to facilitate trade (payments and clearing arrangements) and finance it (e.g. BLADEX). Most of these mechanisms and institutions have functioned fairly effectively, even though the 1980s put special pressure on them; unfortunately, payments and clearing arrangements in Central America and in the Caribbean have not been able to recover from their crisis in the 1980s, while the LAIA mechanism clearly has. As integration becomes increasingly regional (and probably hemispheric), it may be appropriate to think in terms of a regional payments and clearing arrangement, based for example on the broadening of the successful LAIA mechanism. Such a payments and clearing mechanism could both sustain and encourage full regional integration.

The institutions, such as BLADEX, CAF, the BCIE, CAF and LARF, which provide credit for intra-regional trade have on the whole worked well, as have export credit agencies in individual countries, the most important of which is BANCOMEXT.

Relevant policy issues are the following:

- Is there a gap, with insufficient medium-term and long-term finance, provided either by these institutions and/or private capital markets to fund exports of capital goods? Is it necessary to complete private financial markets in this field?

- If there is such a gap, what institution/s should best increasingly focus on these financial activities, which will help fund intra-regional trade, that is more technology and skill-intensive?
- What modalities of collaboration between public and private institutions/ mechanisms would best suit these needs and be the most cost effective from the point of view of using public funds?
- To what extent should regional financial institutions undertake such tasks, or would they be better achieved via national export credit agencies, as occurs in the industrial countries?
- Should existing regional and sub-regional credit institutions possibly be streamlined to avoid overlapping in certain functions, and also to increasingly sustain a more regional and – hopefully – a more hemispheric integration process? (However, any streamlining would have to be carefully studied and carried out, to avoid disrupting any essential functions.)

Three other important policy issues arise. Firstly, how should the rapidly increasing needs to fund intra-national infrastructure (in its broadest sense, to include sectors such as telecommunications and "information superhighways") essential to support trade integration be best met? In this context, it should be remembered that to an important extent the European Investment Bank (created at the same time as the European Community was formed) was largely geared to funding infrastructure to support European integration. It would seem that particularly the IDB, possibly with the support of the World Bank, should take a leading role in such funding, given its expertise in the field. Creative forms of collaboration and co-financing with private capital flows need to be found; and the European Union experience, with the recent creation of a 3 billion ECU European Investment Fund to guarantee private investment in very large intra-national infrastructure projects, provides an interesting example which could be adapted to the needs of Western Hemispheric integration.

Secondly, should further measures be taken to encourage intra-regional FDI and investment from outside the region? To what extent are these flows increased by the prospect of increased integration? To what extent are their effects welfare-enhancing in the medium to long term? To answer those questions better, a fuller understanding of the scale and the impact of such flows seems essential, and careful evaluation needs to be undertaken by national governments as well as regional institutions like ECLAC and/or the IDB.

Last but not least, there is the forgotten financial agenda in the Western Hemisphere integration process which may need to be brought into the discussion. Should financial compensatory mechanisms (used for example for

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labour retraining) be designed on a significant scale to compensate sectors and regions which suffer dislocation from trade integration? Even further, should certain financial mechanisms be created which support integration by reducing extreme inequalities between countries? This may sound radical or even utopian in the context of today's discussion in the Western Hemisphere, but it was, and still is, a central part of the West European integration process, implemented both through credit mechanisms (e.g. the European Investment Bank) and through fiscal mechanisms (e.g. the Structural Funds).

It seems that in the context of Western Hemispheric integration, compensatory mechanisms operate mainly via differential schedules in the liberalisation of trade. Though valuable, a question that needs addressing is whether that is enough to provide long-term support from all sectors and social groups for the integration process.

We can conclude that the policy agenda for the financial aspects of regional integration is a rich and complex one, with very central issues for the success of the integration process.

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Annex 1 Export Financing in Mexico

The Banco Nacional de Comercio Exterior (Bancomext) is responsible for promoting supplementary export financing, with particular emphasis on small and medium-scale enterprise and potential exporters. It operates as a bank of first level by directly financing exporters through its network offices, and at the second level by conducting export support operations through commercial banks. The participation of Bancomext in export financing is considerable. During the 1991-1992 period, it covered 60% of short-term and pre-shipment and post-shipment financing and 100% of long-term financing of investment projects. Almost 75% of loans were channelled to manufacturing firms and export services. To facilitate the access of small and medium-scale enterprise to export loans, Bancomext reformulated its export guarantee to include provision for immediate, unconditional payment. It also introduced credit cards for use by exporters and other financial instruments, that would be accessible to indirect exporters, since Mexico's experience with national letters of credit had not achieved the desired results.

Table 10 Financing by Bancomext 1992-1993
(millions of dollars and percentage)

	1992	1993	Increase (%)
Short-Term	**7,310**	**10,581**	**45**
Production	5,212	6,550	26
Sales	2,098	4,031	92
Long-Term	**1,665**	**3,013**	**81**
Investment Projects in Mexico	1,648	2,933	78
Export Projects	17	80	371
Subtotal	**8,975**	**13,594**	**51**
Guarantees	937	1,010	8
Total	**9,912**	**14,604**	**47**

Source: Bancomext, "Annual Report 1993", Mexico, 1993.

As Table 10 shows, in 1993 Bancomext provided resources for US$14,604 million to support the foreign trade activities of the country, a figure 47% above the one reached in 1992. According to Bancomext, this was due to the stability of the country's macroeconomic framework and to the improvement in the efficiency of the bank itself. Interest rates of the main financial products were reduced. This allowed the bank to continue offering internationally competitive interest rates and terms of payment which, together

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with improved coordination with the financial institutions, contributed to a twofold increase in the number of users to 14,907 in relation to 1992.

Direct exporters and their suppliers were granted short-term credit for a total of US$10,581 million. Of this figure, US$6,550 million were channelled to the production of export goods and US$4,031 million to their sale process.

Long-term financing reached a total of US$3,013 million of which US$1,046 million corresponded to investment projects, US$512 million to imports of capital goods, US$175 million to acquire national equipment units, US$1,200 million to the restructuring of passive of firms with financial problems, and US$80 million to external sales of capital goods. Extension of guarantees reached US$1,010 million.

International Projects

Among others, Bancomext authorised the following credits:

- Mexpetrol of Argentina: credit of US$30 million for exploration and exploitation of oil wells in that country.
- Unión de Empresas del Cemento: credit to buy a cement plant in Mariel Cuba, through the investment-debt swap mechanism.
- Programme FICE-Bovine Meat between Bancomext and the Ministry of Finance: US$10.9 million for the establishment of a financial mechanism to support exporters of meat to Mexico in Central America.
- Credit lines were established with Banco Do Brasil, Petrobas, Banco Mercantil de Venezuela and Banco Sud for a total of US$40 million for the promotion of non-oil exports to South America.
- Export of digital telephone exchanges to modernise the telephone system of Guatemala City and its suburban zones. Bancomext provided support through the credit line with the Central American Bank of Economic Integration (BCIE).
- Joint-Venture between Mexpetrol and a US company for the exploitation of the oil field "Las Casas" in Guatemala. Bancomext provided credit to the Mexican part and participates as shareholder with the firm that will develop the project.
- Perforation of geothermic wells in Colombia by a Mexican company associated with a Colombian one. In El Salvador, Mexican firms were assigned nine projects of generation and transmission of energy.
- Hotel El Prado in Santo Domingo: construction by three Mexican groups.
- Export of 200 units of passenger transport (public service) to a transport cooperative in Guatemala. The Guatemalan commercial banks will support this project with resources from the line Bancomext-BCIE.
- A Mexican firm was given the construction of a dam in the Dominican Republic.

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Table 11 **Bancomext: Financial Instruments to Support Exports**

Instruments	Objectives and Terms of Payment
Productive Cycle (Export Card, CTI, CAPTA, FIME, and CCC/EDC). Beneficiaries: direct and indirect exporters of primary products of the agricultural and fishing sectors; producers of capital goods and firms in the services sector.	Short-term credits, up to 360 days destined to give immediate access to financing for working capital, purchase of machinery and equipment by exporting firms.
Sales (VEXPO, VENEXI, VELPLA and FACTUR). Beneficiaries: direct and indirect exporters; producers and/or commercialisers of capital goods; firms working on real estate projects that generate foreign exchange and buyers of export spaces in fairs or offices in business centres.	Short-term and long-term credits up to 20 years for sales of capital goods. Includes indirect exporters.
Equipment Units (UNE, EXIM and TRANSPORTISTAS). Beneficiaries: Transport firms and those firms included in the sectors supported by the bank that engage in buying machinery.	Medium-term credits for the purchase of machinery and equipment (5-10 years).
Investment Projects (PROIN, TECNO, DTI and INVA). Beneficiaries: direct and indirect exporters who engage in joint ventures with foreign firms or in the construction of industrial estates, tourism projects, business centres or export fairs.	Long-term credits, up to 20 years, for export-oriented investment, technological development, construction of industrial estates, tourist infrastructure and the establishment of strategic alliances with foreign firms.
Factoring (COFIN) (Financial Consolidation). Beneficiaries: direct and indirect exporters.	Long-term credit, up to 20 years for the restructuring of credits provided by intermediate financial institutions.
Promotional Activities. Beneficiaries: all firms in the list of sectors supported by the bank.	Short and medium term (1-5 years) for activities oriented to the promotion and commercialisation of Mexican goods and services (i.e. participation in fairs, publicity campaigns, market studies etc.).

Sources: ECLAC, "Open Regionalism in Latin America and the Caribbean", Santiago de Chile, 1994. Bancomext, "Annual Report 1993", Mexico, 1993.

Comment on "Financial Flows for Regional Integration," by Stephany Griffith-Jones

Mohamed A. El-Erian[1]

Stephany Griffith-Jones' paper goes well beyond financial issues in posing a set of interesting policy questions regarding the prospects for greater economic integration in the Latin America and Caribbean (LAC) region. It may be thought of as consisting of three parts: (i) an objective description of the institutional base supporting regional integration in the LAC region; (ii) a review of foreign investment flows with emphasis on intra-regional foreign direct investment; and (iii) a list of questions regarding the design of a policy agenda aimed at deepening regional integration.

Since I am a believer in comparative advantage, I will leave much of the LAC-specific points to those who have a deeper knowledge of them. Instead, I will address several of the more general questions raised by the paper by considering some basic issues regarding the prospects for greater regional integration, including drawing on the experience of other regions. Needless to say, I will also pose some of my own questions.

My comments will in no way dispute the paper's conclusion – viz., "that the policy agenda for the financial aspects of regional integration is a rich and complex one, with very central issues for the success of the integration process." Indeed, this is a very difficult statement to counter. Rather, I will explore further some of the pillars of this policy agenda, placing particular emphasis on three aspects:

- First, the economic policy environment, including policy convergence and harmonisation issues;
- Second, the interaction between the role of public financial institutions and that of the private sector; and,
- Third, the relation between regionalism, multilateralism and bilateralism.

1 The views expressed are those of the author and do not necessarily reflect those of the International Monetary Fund.

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The Economic Environment

Most studies of regional integration efforts – covering the relatively few successes and the more numerous failures – emphasise the role of economic policy convergence and harmonisation of regulatory and supervisory regimes. At a very basic level, progress in these two areas can be thought of as reducing the transaction costs and uncertainty which serve to inhibit regional activities. They are of increasing relevance the further one seeks to progress along the road of economic integration.

On the economic policy front, particular importance has been placed on relative financial stability between regional partners and the liberalisation of regimes governing trade in goods and services and capital flows. These are essential to the promotion of sustainable regional integration. Perhaps the most vivid illustration of this is in the European Union (EU) where, inter alia, emphasis is being placed on convergence criteria for the main macroeconomic variables associated with the transition to the third stage of economic integration. The criteria include inflation, fiscal deficit, government debt, long-term interest rates, and exchange rate stability.[2] The process is supported by strengthened macroeconomic surveillance which has accompanied the dismantling of barriers to trade in goods and service and capital flows.

Also of importance is the harmonisation of regulatory and supervisory structures – particularly in financial markets. Again, important insights are provided by the EU which has taken important steps in allowing for a "single financial passport" – i.e. enabling institutions licensed in one country to operate throughout the region, with clear delineation of the responsibilities of the host and home authorities. Thus, underlying the EU's regional finance is the harmonisation of regulations on a range of factors impacting credit and investment services. These include capital standards, safety net provisions, exposure limits, treatment of conglomerates, and other prudential and operational issues.

LAC countries have made considerable progress in recent years toward macroeconomic stability and liberalisation, notwithstanding recent developments in Mexico.[3] As Stephany Griffith-Jones' paper points out, this was an important factor contributing to greater flows of foreign direct and portfolio investments; the other being conditions in industrial countries, including

2 For example, the convergence criterion on inflation is that consumer price increases should not exceed that of the three best performing countries by more than 11/2 percentage points. The quantitative convergence criterion on debt is specified as 60 per cent of GDP while that on the general government deficit is specified as 3 per cent of GDP.

3 See for example Sebastian Edwards, *Crisis and Reform in Latin America: From Despair to Hope*, Oxford University Press, Oxford, 1995.

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sharp decline in yields of US financial instruments in the early 1990s.[4] There has also been some progress in the harmonisation of financial regulation and supervision, particularly in the context of the multilateral initiative led by the Basle Committee on Banking Supervision.

In view of these consideration, it would be useful if the following questions were considered:

- Are the achievements in policy convergence and regulatory harmonisation sufficient?
- What are the remaining key policy priorities?
- What can and should provide the anchor for the convergence process?
- To what extent does further progress in these areas affect the arguments regarding the strengthening of the public financial institutions base and intervention vis-à-vis private capital flows?

Also, given the emphasis in the paper on foreign direct investment flows, there is a need to consider the role of taxation – particularly corporate taxation. Indeed, as recognised by the European Commission, the establishment of a common policy in this area is central to the effectiveness of investment flows in supporting integration at the enterprise level.[5] This, inter alia, brings out issues relating to efficiency in the allocation of resources and equity in the distribution of tax revenues across jurisdictions.[6]

Public and Private Institutions

Having considered the main prerequisites for a solid finance structure in support of regional integration, let me turn my attention to some of the issues raised by the paper concerning the structure itself.

The paper lists a host of policy questions regarding the strengthening of public and private finance for regional integration. As the experience of other regions indicates, the case for establishing and enlarging public institutions tends to boil down to political considerations and/or market failure arguments; the latter also provide a basis for interventions in capital markets.

It is clear from the paper's survey of existing institutions that there is already an extensive and functioning regional institutional base – a base that

4 Guillermo Calvo, Leonardo Leiderman and Carmen Reinhart, "Capital Inflows and Real Exchange Rate Appreciation in Latin America", IMF Staff Papers, March, 1993.

5 G. Fitchew, "The Single European Market and Tax Harmonisation", In: M. Gammie and B. Robinson (eds.) *Beyond 1992: A European Tax System*, Institute for Fiscal Study, London, 1989.

6 For an analysis of issues that influence the flow of foreign investment under alternative tax regimes, see Michael Keen, "Corporation Tax, Foreign Direct Investment and the Single Market", In: L. Alan Winters and Anthony Venables, *Economic Integration: Trade and Industry*, Cambridge University Press, Cambridge, 1991.

goes well beyond what exists in other developing country regions. Of course, there is always room for adaptations to ensure greater effectiveness in promoting regional integration. However, such adaptations must be assessed in terms of complementarity with, rather than substituting for, private market functions. To this end, it would be interesting if the paper were to explore further the financing of regional projects. Some of these projects provide examples where, inter alia, difficulties in assigning clear property rights can serve to discourage the sufficient availability of private financing for what are economically efficient regional activities. Indeed, in some parts of the world, some of these projects have constituted challenges not only for private financing but also for official multilateral financing.

I would also take the opportunity to caution against oversimplifying the arguments for intervening in capital markets. I am thinking in particular of the paper's treatment of the adequacy of medium- and long-term financing of exports of capital goods. It is true that private capital inflows have not necessarily been aimed at promoting the finance of a particular type of activity. But this is not necessarily the indication of a market failure which warrants intervention to direct flows to particular uses. A key issue is the overall economic environment. As illustrated by the differing experiences of countries in Asia, Latin America and the Middle East, the macroeconomic policy mix itself can play an important role in promoting longer-term capital flow and limiting the share of more volatile short-term flows.

Bilateralism, Regionalism and Multilateralism

Let me now turn to the third and final issue – that relating to the question of "bilateralism versus regionalism versus multilateralism".

This issue has to be confronted very early on when discussing the economics of regional integration. By simplifying the vast amount of work done in this area, one can point to two general conclusions: first, multilateralism tends to dominate in an absolute sense; and second, regionalism is considered, in most cases, superior to bilateralism especially if it is based on an outwardly-oriented strategy and is a stepping stone to multilateralism (elements of the so-called "new regionalism").

Of course, there is a range of analytical complications. This is especially the case when the analysis has to deal not only with the existence of overlapping arrangements within the region, but also with the interdependence and game theoretics associated with the simultaneous formation of regional blocs in different parts of the world.[7]

7 See for example papers in Jaime de Melo and Arvind Panagariya (eds.), *New Dimensions in Regional Integration*, Cambridge University Press, Cambridge, 1993.

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It is also important to remember that there are different forms of regionalism. These range from a series of sub-regional groupings to a region-wide nondiscriminatory liberalisation. Indeed, the question is not just what form of regionalism but also the implications of the simultaneous pursuit by some countries of different forms of regionalism.

While not explicit, Stephany Griffith-Jones' recommendations on financial arrangements may be read as supporting the region-wide concept – thus her emphasis on broadening regionally the successful LAIA payments and clearing arrangement. I think that this is the correct approach, albeit the more difficult one to implement given the economic and financial divergences among some of the countries in the LAC region.

However, if one follows this line, it is important to also consider the role and effectiveness of potential compensatory financial mechanisms. The economic argument for these mechanism relies on two elements: the relative immobility of factors of production and the resource reallocations implied by the changing relative price structure inherent in a regional integration process.

OPEC is often viewed as a case where the lack of compensatory mechanisms has undermined at times the cohesive behaviour needed to achieve collective objectives. The EU, by contrast, has a number of such mechanisms. These range from Structural Funds – including the funding of mutually agreed-on projects in regions and countries below a specified income threshold – to balance of payments assistance provided on conditional terms and the operation of the Common Agricultural Policy.[8]

Of course, these mechanisms are not without problems. They raise issues of moral hazard and, if not effectively operated, can serve to retard the regional integration process. These risks are especially pronounced in the context of regional groupings that find it difficult, particularly for political reasons, to impose sustained discipline on their members.

Given its vision for financial structures supporting a region-wide integration process, perhaps Stephany Griffith-Jones' paper could be followed up by a discussion of:

- the role of compensatory financing arrangements in the LAC region;
- the potential for adverse incentives that result in a slower integration process; and,
- the policy implications.

Let me conclude by thanking Stephany Griffith-Jones for an extremely useful paper. My comments suggest that there is a need to build further on

8 An analysis of these mechanisms may be found in Charles Bean, "Economic and Monetary Union in Europe", In: *Journal of Economic Perspectives*, Fall 1992.

the analysis contained in the paper by looking at the importance for regional finance of four main issues:

- greater convergence in macroeconomic policies;
- progress in harmonisation of regulatory and supervisory regimes across the region;
- the complementarities between the role of private and public institutions; and,
- the role and design of compensatory financing mechanisms.

These essential building blocks are an integral part of any analysis of the case for and against creating and enlarging financial institutions, as well as intervening in the private capital markets.

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Comment on "Financial Flows for Regional Integration," by Stephany Griffith-Jones

Barbara Stallings

I like Stephany Griffith-Jones' paper because it provides a good deal of information on an important aspect of hemispheric integration we don't know very much about. Finance and investment are generally acknowledged to be the most important aspects of hemispheric integration. That is why Latin American countries are interested in negotiating integration mechanisms with the United States. On the other hand, in terms of intra-Latin American integration, there is more of an emphasis on the importance of trade. This may be a distinction between hemispheric vs. intra-Latin American integration that we want to keep in mind.

There are three different types of trade and financial links discussed in this paper. First, we have finance directly promoting trade and investment via the current payment mechanisms and trade finance. Second, finance indirectly promotes trade and integration via foreign direct investment among countries. And, third – the opposite of the second item – trade and integration promote finance and investment via increasing the integration process and leading to increased capital flows.

The first of these mechanisms – finance directly promoting trade and integration – has been present in all the processes of hemispheric integration, going back to the ALALC-LAFTA days in the earlier post-war period. Until now, these mechanisms have been limited to the intra-Latin American aspect of hemispheric integration and they have not reached the United States; the US has not participated in these kinds of mechanisms. In part, these mechanisms began early in the post-war period because of balance of payments problems, and Stephany talked about the fact that their importance declined in the 1990s. But this type of finance also increased during the debt crisis of the 1980s. I think there is some clear evidence of the link between availability of international finance and these mechanisms becoming more important in financing trade. Even now, however, they remain at a very high level: according to the data in Stephany's paper nearly 70 per cent of intra-Latin American imports are financed by these mechanisms.

The second process that Stephany talks about – finance indirectly promot-

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ing trade and integration via foreign direct investment – is a newer process in so far as we are talking about investment among Latin American countries, basically a phenomenon of the 1990s. But, of course, if we look at hemispheric integration, US investment in Latin America is really a very old story. There are two different processes here: one is addressed in the paper and the other is not. The one that is not addressed is investment increasing trade via intra-firm transactions, whereby firms engaging in foreign investment import inputs and capital goods into the host country and thereafter export the goods they produce back to their home country. The mechanism that Stephany does talk about in the paper vis-à-vis this topic is a different one. That is: increased investment is likely to lead to de facto integration, which in turn, at least in some cases, will lead to de jure integration. If we are looking at the Mexican-US example, this is exactly what happened. There was de facto integration across the border at a variety of levels, which eventually led to the agreement to formalise this in the NAFTA agreement. There are some observers who have discussed the Chile-Argentina relationship in the same way, that it was the spontaneous Chilean investment in Argentina which later led the Chilean government to begin to approach Mercosur to try to negotiate a more formal kind of relationship. So there is at least some evidence that the second process indeed does work.

The third process discussed by Stephany – that trade and integration may increasingly promote investment itself – is the opposite of the second point. This is an argument that has been made, but I think the situation is less clear than may be implied by some of the discussion we have heard. It seems true that greater security about rules for foreign investment will lead to greater amounts of investments. But on the other hand, if we ask whether firms are trying to increase their sales by investing in other countries – for example, is the United States trying to increase its sales in Latin America by investing there? – then the situation becomes a bit less clear. It was certainly true in the import-substitution industrialisation period, when there were barriers to trade, that if you wanted to sell in the domestic market, you had to invest there. But in the current period of more open markets, the situation may even operate in the opposite way. For example, a number of Japanese industrial firms that were operating in Latin America have decided to close down their local operations and export from Japan to Latin America because it is cheaper and they can make higher profits. So it is not totally clear that greater integration will necessarily lead to greater investment.

Dynamics of Other Regions

There have been a number of comments, both in Stephany's paper and in the previous discussion this morning, about a qualitative distinction between

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integration processes in different regions, but I think it is also important to talk about a quantitative distinction. In this quantitative distinction, Latin America, and the Western Hemisphere more generally, are far behind Europe and Asia. If we look at trade among European Union countries, more than 60 per cent of those countries' trade is now with each other. In terms of the Asian region nearly half of the trade of the Asian countries is now among themselves and the share has been rising very rapidly. In the Western Hemisphere, by contrast, only 22 per cent of total trade occurs among hemispheric countries.

An interesting aspect of what has been going on in Asia is the different types of symmetry in the Asian region and in the Latin American region. With respect to export markets, developing Asian countries – the NICs and ASEAN – are more important to Japan than Japan is to them. That is, only 17 per cent of developing Asian countries' exports are sold in Japan, while 34 per cent of Japanese exports are sold in developing Asian countries. In the Western Hemisphere the symmetry is the opposite of what you find in Asia: 15 per cent of US exports are sold in Latin America while 43 per cent of Latin American exports are being sold in the United States.

There is a similar situation if you look at investment, the topic of Stephany's paper. Investment flows among EU countries now reach about 63 per cent, i.e. 63 per cent of EU investment is in other EU countries. In the case of Asia, we've got a quite different situation than we saw in the case of trade; 16 per cent of Japanese investment goes to developing Asian countries and about 80 per cent of developing Asian countries' investments are in other developing Asian countries. Those amounts are becoming quite large although, as Stephany said, our data are not really good in terms of investment flows; best estimates are of at least 5 billions dollars a year of investments among developing Asian countries in the 1990s.

In the Western Hemisphere, the figures that Stephany reports are a good deal less than a billion dollars, though she says that these may be underestimated. So, let us say, a billion dollars in Latin American countries' investment goes elsewhere in the hemisphere compared to 5 billion dollars for the developing Asian countries. Brazil, Mexico and Venezuela, by far the largest investors, send most of their money in the United States, whereas only the medium-sized countries, Chile, Colombia and Peru, invest heavily within the region. So there is quite a different dynamic going on in Latin America compared to Asia.

While all these figures seem to indicate a fairly strong relationship between trade and finance within regions, the causality is somewhat unclear. There seems to be an interactive process of some sort going on, probably a mutually reinforcing one. We must understand this causality better if we are to answer the question that Stephany's paper poses: what role can finance play in the

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future in increasing trade flows within the Western Hemisphere or among the Latin American countries themselves?

Compensation and Trade Finance

Let me finish by coming back to some of the compensatory mechanisms that are discussed in the paper. Most of the mechanisms that Stephany talks about are intra-Latin American; the exception is NAFTA in possibly promoting US investment in Mexico. The important analytical and policy question, once we move to discuss hemispheric integration as opposed to intra-Latin American integration, is to what extent the United States will begin to participate in these mechanisms. It seems clear that, at least at this point in time, unlike the situation in Europe, the US government has no interest in providing compensatory financial flows to the Latin American region. There is indeed a lot of discussion and some action in terms of providing compensatory relationships within the United States itself. Firms and workers who supposedly are being hurt by the NAFTA agreement can get access to training funds and other kinds of compensation. But this will not work between the United States and Latin America. For example, when US Commerce Secretary Ron Brown was here last year I asked him if there are going to be any kind of mechanisms set up such as the European structural funds for Mexico or for other Latin American countries. His answer was: "Absolutely none. If Latin America wants to join NAFTA or some hemispherical organisation, they must have other reasons than trying to get compensation". Thus, the moral hazard issue is unlikely to arise in this particular context.

Trade finance is somewhat different because there is the Export-Import Bank financing available, but this is a very one-sided kind of relationship as well. The Exim Bank exists to promote US exports to Latin America (and elsewhere), not to promote any kind of common goals within the hemisphere. Therefore, some questions arise: Can we find mechanisms that might promote common goals within the hemisphere? Could some kind of intra-regional organisation like the IDB play a positive role? Could private trade finance play a role in changing the situation? These are some of the policy issues that this paper suggests.

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Floor Discussion of the Griffith-Jones Paper

Stephany Griffith-Jones' paper and the subsequent comments by Mohamed El-Erian and Barbara Stallings provoked a lively discussion which seemed to be inspired more by the participants' differences in experiences and backgrounds than by their differences in opinion. Participants brought in the perspectives of their respective countries or regions and presented views which were clearly influenced by their working experience in either the official or private sector, or in policy-oriented academic research.

The Caribbean Experience

Fay Housty, programme manager at the Caribbean Community (Caricom) Secretariat, started off the discussion by supplementing some information on the Caribbean experience in financial integration. She briefly reviewed six public arrangements that were meant to foster financial integration but which, in most cases, had failed.

The first mechanism mentioned by Housty was the Caribbean Multilateral Clearing Facility (CMCF). "Stephany Griffith-Jones indicated that one of the reasons why the facility failed was because of the accumulation of debt by Guyana and the balance of payment problems of Jamaica. She also indicated that part of the failure might have been because of the lack of bilateral credit ceilings, but the formal structure of the CMCF did have bilateral credit ceilings. However, in the operationalisation of the facility these individual credit ceilings were waived. Countries were allowed not to settle their outstanding liabilities to the full. That was the major reason for the failure of the CMCF."

The second mechanism was the Caricom travellers cheques facility. "This facility – which was meant to facilitate the movement of goods and services in the region – had some initial success, but it has failed within the last two years mainly because of a lack of confidence by the purchasers due to the instability of the currency in which the traveller cheques were denominated." The lack of use of the Caricom traveller cheques was also caused by the liberalisation of certain economies and the more extensive use of the US dollar after the relaxation of exchange controls, Housty explained.

A third attempt at financial integration in the Caribbean – which did not meet with much success either – was the idea of establishing a Structural

Adjustment Reserve Fund. "There was much discussion of this facility in the 1970s," Housty said, "but it was never established because it would have meant too much dependence on one country. There was only one country in surplus, while all the others were in deficit. And this overdependence on a single economy made it very difficult to introduce such a system."

A fourth instrument for monetary integration in the Caribbean was the establishment of an export credit facility. "Again, it was a non-starter," Housty explained, "because the proposal was that this facility should reside in the Caribbean Development Bank. The external member states of the Bank did not support the facility and considered that it should be established at the national level or that member countries should take advantage of the arrangements within BLADEX to support export credit."

A fifth mechanism for financial integration was a soft-loan window of the Caribbean Development Bank. "This Bank was established in the Caribbean not only to facilitate the development of infrastructure and give balance of payments support, but also to provide special assistance to the least developed countries of the region," Housty said. "In the Caribbean the countries are grouped into two types: the larger ones (Guyana, Trinidad and Tobago, Jamaica and Barbados) are considered more developed countries, while the countries of the OECS (Antigua, Grenada, Dominica, Saint Kitts-Nevis-Anguilla, Saint Lucia, Saint Vincent and Montserrat, as well as Belize) are considered less developed. The Caribbean Development Bank set up a soft-loan window to allow these countries to participate in the integration movement. Similarly, the Caribbean Development Bank accesses a channel for IDB funds for the small or less developed countries that are not permitted to join the IDB because of their size."

A sixth instrument for monetary integration was the Caribbean Investment Fund. "This Fund was set up to foster private investment by, for example, assisting in the financing of venture capital. At the beginning of last year the member countries, with the exception of Barbados and the Bahamas, also agreed to introduce a double taxation agreement. So far three countries have signed that agreement and it is operational among those three."

Another attempt at financial integration by the Caribbean countries was the decision to establish a monetary union, Housty stated. "The decision was based on what they called 'a two-stage three-tier system', in which criteria were set up for some convergence in macroeconomic policy; the countries were divided into two groups in terms of the pace at which monetary union could be achieved. In February 1995 there was a discussion in Belize on the progress made towards monetary union, and it was observed that macroeconomic convergence has not been achieved nor some of the other criteria which had been identified. It was agreed that as a first step towards monetary

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union we would have currency convertibility from July 1995. Our central bank governors also agreed on closer collaboration to achieve a low level of inflation and exchange rate stability."

With respect to capital markets, Housty noted that the three countries that have stock exchanges recently decided to enable cross-listing and cross-trading of securities. "In the initial stages this cross-listing and cross-trading did stimulate some investment flows. However, again, because the base is too narrow and because the markets in these countries are unstable, the degree of stock exchange activity is rather low."

Fay Housty concluded her intervention with the observation that the Caribbean region – i.e. the Caricom as currently defined – may be too small or too dependent on one or two economies to make proposals such as the clearing facility and the long-term structural adjustment facility feasible. She therefore agreed with Griffith-Jones' suggestion that the Caribbean should link itself to the larger Latin American region. Similarly, with respect to the stock exchanges in the Caribbean, Housty thought it would be useful to link the Caribbean Stock Exchange with other stock exchanges in Latin America. She also endorsed Griffith-Jones' view that regional integration would need to be accompanied by some sort of compensatory mechanism. "The move towards hemispheric free trade is for us a great challenge and I was very stimulated by Stephany's remarks about the need for compensating arrangements, because we in the region see ourselves as needing special arrangements or some special consideration as we move into the wider level."

Investment and the Roles of the Public and Private Sectors

Various participants dwelled on the nature and implications of intra-Latin American investments.

Ricardo Ffrench-Davis, principal advisor on economic policy of ECLAC, corroborated Stephany Griffith-Jones' finding that a significant part of reciprocal investment in Latin America was not associated with the trade in goods. "That is very clear in the case of Chile. To a large extent Chilean investments were encouraged by capital gains offered by privatisation processes and by capital gains which could be obtained in the stock exchange when stocks were going up in most of the middle-sized and large-sized Latin American countries. Only a minor part of Chilean investment – but a very fast-growing part – was used to increase the trade in goods by, for example, establishing a producer or a marketing office in another country. However, the fact that growing reciprocal investment is accompanied by these more structural relations at the firm level is important, because if problems arise in the future, you have the structural relations that will enable trade to survive better in difficult circumstances."

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Augusto Aninat, president of a large Chilean export firm, emphasised that foreign direct investment and intra-regional trade are interlinked through the operations of private enterprises to which the Latin American markets in manufactured products are very important. "This intra-regional trade in manufactures is to a high degree intra-industrial and intra-firm trade, and intra-firm trade is operated largely by transnational corporations who came to Latin America during the import-substitution era of the 1960s and 1970s in order to have entrance to the nationally closed markets of the time." Aninat said that if Latin American countries wanted to obtain additional inflows of foreign direct investment, they should beware of creating conditions that might result in losing part of the already existing stock of foreign direct investment (of around 100 billion dollars) which has been provided by these transnational corporations.

According to Aninat the rise of manufactured trade between, for example, Argentina and Brazil is not only a consequence of the liberalisation of trade, but also of administered special trade regimes. "There are special protocols which give protection to transnational corporations' subsidiaries which are located in these countries. One well-established example is the automotive industry. Exports by these industries in Argentina and Brazil are one of the main explanations of the boom in the trade in manufactures between these countries. Another example is Maquila Automotive, an industry in Mexico which is connected with the United States. NAFTA is going to liberalise trade in a 10-year period, but for the moment there are special trade regimes that favour the exports of this kind of industry."

Aninat believed that these industries – the case of the automotive industry is a notable example – remain in Latin America because they enjoy some kind of protection. "A complete and sudden liberalisation would perhaps tempt many of them to go away and make offers to the Latin American markets from outside the region. This does not mean that it is good to have this kind of protective regime, but it does mean that liberalisation has to take into account the necessary competitive adjustments that these industries will have to make. The challenge for us is to try to get inflows of new foreign direct investment and at the same time retain the foreign direct investment already located in the area."

Claudia Schatan, economic affairs officer at ECLAC-Mexico, elaborated on the nature of intra-Latin American foreign direct investment. "Why doesn't foreign direct investment of Latin American countries within the region seem confident? It doesn't seem confident enough to make new investments, risky investments in the export-oriented areas. They concentrate on acquiring enterprises that have been privatised or private enterprises that already exist. In this sense something is wrong. Integration is not leading the region to a more competitive stance in the world economy, which is what one

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might expect from an additional effort at foreign direct investment. Take, for instance, the case of Costa Rica and Mexico. After they signed the free trade agreement, and Mexico had all the guarantees for foreign direct investment that NAFTA gives because that was Mexico's requirement from Costa Rica, many Mexican entrepreneurs came to Costa Rica to buy Costa Rican firms. Then the Costa Ricans were arguing that no new investments and no new projects were coming in. Why?"

Schatan also pointed to the speed at which investments are made and withdrawn in Central America. "You can see foreign direct investment moving very quickly from one country to another within the Central American region – perhaps also within the Caribbean – according to the conditions that each country offers. If El Salvador is offering lower wages, then Costa Rican capital and Guatemalan capital seem to be going to El Salvador. So while investment is going to areas that export and that can be competitive, there is the problem of a very foot-loose kind of investment, not from the US or the Koreans, but from the Latin American investors."

Renato Baumann, economic affairs officer at ECLAC-Brazil, referred to lessons to be learnt from the experience of Mercosur, and in particular from the evolution of the integration agreement between Brazil and Argentina. "There are some lessons that might be of interest. First of all, Stephany's paper tells us that there is a long-standing sort of tradition of bilateral investment flows in the region being concentrated in the tertiary sector. In particular in the Brazil-Argentina experience, I would stress that it is not the tertiary sector in general, but the commercial banks segment in particular. The integration process started with investments in the banks and then led to investment in the secondary sector, and, more recently, to the acquisition of land in the primary sector. Why was investment in the commercial banks so important for the whole process? What motivated it in the first instance? Another lesson to be learnt relates to what has happened with the compensatory mechanism that was originally designed to reduce bilateral trade deficits. If there was a trade deficit over a given percentage, an investment fund had to be created to compensate for structural deficiencies of the deficit country. This trigger mechanism was in the original Brazil-Argentinean agreement, but it disappeared in the Mercosur treaties. Why?"

Focusing on the role of financial flows in development, Baumann raised the question of the best way to finance long-term growth in the region. "Stephany's paper does not pay sufficient attention to one important aspect, which is credit guarantee. There is a multitude of institutions, as Mohamed El-Erian stressed, but exactly how do you configure a mechanism so that the smaller and medium firms can have access to credit? – not only institutional credit in BLADEX or some regional institution, but also credit that is available from all the pension funds around the world and all the liquidity we

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have. Why do medium and smaller firms have difficulties in gaining access to those resources?"

Baumann also wondered why the need for development bank financing is stressed time and again rather than following the Anglo-Saxon way of financing long-term investment via stock exchange. "Why is there no integration between the stock exchange markets in Latin America? Probably it is connected with the way the stock exchange markets function – they are heavily concentrated in a few stocks. Certainly it has to do with recent experiences of some countries. At least until last month, very frequent comments were made in Chile in terms of the migration of liquidity – ADRs being captured, resources being captured in Wall Street meaning that some liquidity was going abroad – as a result of difficulties with the local stock exchange."

Antonieta del Cid, vice-president of the Central Bank of Guatemala, thought that too much attention was focused on the importance of institutional arrangements: "Is it the institutional arrangements that facilitate or stimulate larger intra-regional trade, or is it the other way around, i.e. the intra-regional trade which stimulates these institutional arrangements? The failure of, for instance, the clearing and payment arrangements in the Central American region was due exactly to what Stephany points out in her paper. Even after the adjustments of 1991, only a small part of intra-regional trade was channelled via this mechanism (in 1992, around 15 per cent) because imbalances of trade between Central American countries remained high and thus a large proportion of the transactions had to be settled in hard currencies. However, last year some commercial banks of Guatemala, Costa Rica, and El Salvador virtually replaced this public clearing and payment arrangement by creating a Central American current account! An importer in Guatemala from El Salvador can now pay in local currency, and it is the same in El Salvador and Costa Rica. Other commercial banks are following the same mechanism. Although it may be too early to talk about a success story, I think this is an example of something that could not be accomplished by the government or the public sector and is now being accomplished by the private sector. Perhaps in the end the market is going to find the way to replace these institutional arrangements and create the adequate mechanisms."

The Asian Experience

Percy Mistry, an Indian economist engaged in both policy-oriented research and private sector activity (he owns a merchant bank in India), provided an Asian perspective. "As an Asian who was involved in the way in which Asia developed its intra-regional network in the 1970s and 1980s, I

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would like to share some elements of experience and their relevance and irrelevance for Latin America. I keep worrying that people look at Asia and have a tendency to draw rather simplistic and wrong lessons from the Asian experience.

The first thing which strikes me is that in all these discussions in Latin America, Africa, South Asia – where you have brilliant economists and very effective institutions in which economists work – the issues get confused because economists substitute their judgements for what and how business people think. The fact of the matter is that in any policy-driven and institution-driven regional integration process – including the European Union – whereas policymakers think that they are reducing costs for businesses, business people perceive it in exactly the opposite way. They see the transaction costs, the information costs, the cross-border risks and the familiarity premium problem as much easier to cope with when they are dealing directly with one other, than if they are dealing through bureaucracies. It is not just a question of bureaucratism or non-bureaucratism, but of how businesses react to bureaucracies. Very often when I talk to policymakers in Latin America and Africa they actually believe that they know how business people think, but they don't! They haven't a clue! Policymakers are naturally risk-averse, terribly intelligent, and awfully thoughtful, while business people are none of these things! They look at an opportunity and either they move or they don't.

Now I will say something that may strike you as a contradiction to what I just said, but really it isn't. It's of critical importance to understand the so-called 'cascade' or 'flying geese' effect – both by industry and by country – in Asia. People often wonder how intra-regional developments in Asia actually took place without anybody – at least, from the policy point of view – guiding them. But in fact, when you were involved in some of these things as I was, you saw that they were being guided very carefully by long-term planning by major corporations which had a 5, 10, 15 year horizon (which, by the way, I find completely lacking in the Western Hemisphere whether it is in the North or in the South). I was working with Japanese and Korean business people who were literally doing scenario-planning for 2000 and 2005, by industry, by country.

However, this notion that Asian integration is entirely market-driven is too simplistic. Indeed, it was driven by large firms, first by Japanese multinationals, then by Korean and Taiwanese multinationals, then by Hong-Kong/Singapore multinationals and now by Malaysian/Thai/Indonesian/-Philippine multinationals. But these multinationals have very effective relationships to their governments, so it is misleading to simply classify the Asian experience as market-driven integration! It is not. It is a very carefully planned, very thoroughly executed process. But it is a process in which

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business people have a driving role, not governments! They use governments, and governments let themselves be used. It is not the government's feeling that they should drive the process, and that again is very different in Latin America and in Africa, and even in South Asia.

Another aspect of this term 'market-driven' is that most of the intense integration in Asia has been cost-production driven. In the early phase it was 'competitive tax incentivation-driven' but that was very quickly abandoned. Within 5 or 6 years Asian countries decided not to compete with each other and offer favours and tax holidays in their tax regimes because they were cutting each other's throats. They cut that out and discovered the merits of a basically uniform, stable, low-cost macroeconomic regime very quickly.

The reason the Asian machine has kept going so long is because this cascade has been planned and at each stage of planning somebody else has entered into the game. It started off with the Japanese multinationals, but then involved the Koreans and all the others. The next phases are Indochina and South Asia. In fact, Asian businesses are looking now – and not only looking but they have been very effective investors – at Mauritius. They are also looking at South Africa and Madagascar.

So you have this full concept of regional integration based on the export of an entire production platform and everything that it entails: the technology, the finance, etc. One of the things that has been left out in Stephany's paper which I would suggest as a theme, is the role of intra-industry and intra-firm credit facilities to suppliers and buyers. In Asia this has played an incredibly powerful role. Not the banks, not the credit insurance companies, but the firms on their own account are providing the supplier and buyer credits – sometimes supported by governments, but in Asia there is very little of that; only in Japan is there major support. The other thing you see is that integration in the services industry, particularly in financial services, has often preceded integration in manufactured goods. In fact, the financial services industry has led integration in Asia.

Then there is the whole issue of ethnicity, which plays a very powerful role in Asia. If you look at the major driving forces of investment – apart from Japanese investment in Korea and Taiwan – you see that investment from Taiwan, Hong Kong and Singapore into all of the other Asian countries has been heavily concentrated within the overseas Chinese communities: intra-firm, intra-family, intra-well-known, and it is even broken down by ethnic type. The Shanghainese will invest with the Shanghainese, the Cantonese will invest with the Cantonese, the Fuchianese will invest with the Fuchianese. The peculiar thing is that Asian development is based on a view of exploiting the *world* market, but actually has facilitated *regionalisation* because of the premium it attaches to 'familiarity with the environment'.

Asia started out much poorer than Latin America and is now richer than

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Latin America. Asia started out with just as much American multinational presence as Latin America did in the 1960s and 1970s, and now the American multinational presence in Asia is minimal. There is virtually no European presence at all. And what has really characterised Asia is the emergence of very powerful regional corporations, which are now becoming transnational corporations. The rate at which people from Singapore, Hong Kong, China and Malaysia are buying up the UK is not funny. This year, I suspect people will realise that investment in the United Kingdom from Hong Kong, Singapore and Malaysia has exceeded investment from Japan.

A thing that came out strongly in Stephany's paper was the role of official finance in facilitating integration. When you look for the official role in Asia, there is none. If you abandon the Asian Development Bank tomorrow, Asia will develop without missing it. Perhaps the only country to which the ADB is making a significant difference is Bangladesh, but you could forget about regional institutions like that. There is no regional clearing facility, it is all done through commercial bank to commercial bank arrangements. There is no support whatsoever, no official agency underwriting exchange risk, no official agency underwriting commercial risk. When two firms decide to do something together, they get their banks to do something together.

In Asia there has also been a tremendous amount of industry-led backward and forward integration. When I said that there was a cascade by country, one should not forget the cascade by industry: first textiles, then footwear, then electronics; first consumer, then industrial; and then a tremendous boom in diversification. Automobiles are now beginning to play a very significant role in the development of backward integration in glass and steel and a forward integration role in terms of global marketing arrangements which are shared.

Stephany and others have raised the issue of capital markets. I agree that this perhaps needs to be looked at a bit more intensively in future research, but the funny thing in Asia is again that nobody has attempted to plan to integrate regional capital markets and yet, in a peculiar way, they integrate very well. Essentially regulatory harmonisation has come about through regulatory competition rather than through regulatory cooperation. Everybody in Asia has wanted to offer a better regulatory deal, only on certain kinds of issues regulators have cooperated."

The Mexican Crisis

Because of the importance of the Mexican peso crisis that erupted in December 1994, a long discussion took place on the implications of this crisis for the process of economic integration in Latin America.

In the view of Ricardo Ffrench-Davis there was a clear link between

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Mexico's currency crisis and its entering into NAFTA. "The appreciation of the exchange rate of the Mexican peso between 1991-94 – which increased imports from the US and contributed to the one digit inflation – enhanced very significantly the probability of being accepted as a member of NAFTA."

According to Ffrench-Davis, the Mexican government was so keen on entering into NAFTA that macroeconomic policies were subordinated to that goal. "What was happening in the process? The appreciation of the exchange rate – the real exchange rate, not the nominal one – was encouraging additional capital inflows. In a sense, you got a perverse dynamic. The aim of entering into NAFTA helped to keep up the exchange rate, the appreciation of the exchange rate encouraged the inflow of capital, the capital inflows allowed the exchange rate to lag more, and so on. You got a dynamic which could go for 1, 2, 3 or 4 years. It is very difficult to know when it ends, but one knows for sure that when this process is so massive – in the case of Mexico the stock of external liabilities was growing very fast: an additional 20 billion in 1991, 23 billion in 1992, 25 billion in 1993, 29 billion in 1994 – it will end, whether you are in NAFTA or not, whether you are in Mercosur or not, the European Union or not, when it is so massive, running at 8 or more per cent of GDP for three or four years."

Why did Mexico not try to stop the appreciation of its currency to avoid aggregate demand growing faster than the GDP? "That is not easy to do when you have free capital inflows and when world capital markets have a large supply of cheap funding. In 1992, 1993 and even in 1994 it was very cheap – in real terms – to get money from the US market or the international capital market. Mexico's entering into NAFTA raised expectations and made the country an attractive investment opportunity for capital markets. Mexico did not have the problem of a too large direct foreign investment – which was fairly small, 5 billion in 1993, maybe 8 billion in 1994, and could be absorbed quite well by Mexico – but of a too large inflow of short-term capital," Ffrench-Davis explained.

Mexican economist Jaime Ros stressed that the Mexican crisis was the result of both market failure and government failure. "It is this combination of markets and government failing together that made the crisis so acute and the present mess so big. The market failure has to do with foolish speculation, grossly misinformed and over-optimistic expectations about the profits of the Mexican economy which supported for too long – for about three and a half years – a currency that was very clearly overvalued since mid-1992. The government failure has to do with the policy of following a real appreciation of the peso at the time of a very radical process of trade liberalisation and a dramatic fall of the domestic savings rate – especially the private savings rate. According to the textbooks on international economics, you can implement a very radical process of trade liberalisation only if you

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compensate with the real depreciation of your currency, otherwise you get into trouble."

Jaime Ros pointed out some of the implications of the Mexican crisis, both for Mexico and for the process of economic integration in Latin America.

"One consequence is that the problem of capital inflows is over. We are unlikely to see bullish speculation in financial markets for years to come, partly because financial confidence is bound to remain very shaken, partly because of the high interest rates in the US. And as long as the present situation doesn't degenerate into a credit crunch 1982-style, I think this will have positive consequences for Mexico and Latin America. One positive consequence is that it will force exchange rate policies to focus on production and growth rather than leaving the exchange rates in the hands of the financial markets. As long as this is the case, we may see a change in the composition of investments from abroad in the right direction. One of the problems of the investment boom – financial investment boom and foreign direct investment boom – in Mexico in the years preceding the current crisis was not only that the composition of investment was very biased towards short-term financial flows with very little foreign direct investment, but another problem – and a serious one – was that the composition of foreign direct investments itself was increasingly biased towards the non-tradeable rather than to the tradeable sectors. Putting it in simple terms, we were getting McDonalds, Wallmart and Tacobell rather than Toyota and IBM, and it makes an enormous difference! Not only because of the kind of jobs and productivity gains that you may get from IBM and from McDonalds – that is not the major point – but also because the non-tradeable goods sector cannot become an engine of growth. It is only the tradeables sector that can become an engine of growth in an open economy.

The second implication for the process of economic integration is – and here we should recall the textbooks of 10, 15 years ago – that in processes of unilateral or bilateral trade liberalisations (that will proceed necessarily at an uneven pace and starting from different initial conditions), we are bound to produce currency realignments, precisely because the trade liberalisations proceed at an uneven pace and start from different initial conditions. The challenge is then how to manage these currency realignments, how to prevent them from degenerating into major exchange rate or even financial crisis."

Renato Baumann raised the question of whether the crisis in Mexico – which has been aiming so much at the US market – showed the need for diversifying trade and pegging the currency to a basket of currencies instead of the US dollar. "Most of the Latin American countries usually peg their currencies to the US dollar. One of the lessons of the Mexican crisis may be that you should peg to a basket of currencies, as Chile did a couple of years ago," Baumann said.

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Jaime Ros observed that in the case of Mexico, the dollar is *the* currency in the relevant basket. "So the issue is not so much whether you peg against the dollar or you peg against the broader basket of currencies. The issue is whether you peg or not. I mean, you can either continue to peg the peso at say 4.50, 4.75 to the dollar (assuming that the currency situation stabilises) or follow a policy of real exchange rate targets. This is the important debate at the moment. I can see the advantages and disadvantages of both options, but I tend to be in favour of real exchange rate targets."

Shahen Abrahamian, officer-in-charge of the Global Interdependence Division of UNCTAD, argued that one should forget about the idea that private capital markets would ever produce the right amount of flows.

"I agree with almost everything Jaime Ros said, but he gave the impression that this Mexican crisis was a sort of salutary shock, and now the flow of capital would be right. I think that private capital flows will always be either too much or too little. If the right amount goes, that will increase confidence and more than the right amount will go. If less than the right amount goes, that will deter confidence and less than the right amount will go. The typical pattern will be either a glut or a shortage. And this is particularly worrying in a context like Latin America where short-term capital is taking the place of long-term capital.

There has been the notion that somehow Latin America has been getting itself into a kind of quasi-Asian type of development. I think this is completely wrong. In Asia, by and large, there has been a tremendous boost to the competitiveness of the developing countries in the region. This has not happened in Latin America. The capital flow from the United States to the South of the region is superficially like the Japanese capital flow to the rest of the region. But there has not been the relocation of production and the real structural changes that occurred in Asia. You haven't had the push from Japan or Korea under the impact of rising real wages. The situation in Latin America is much weaker than in Asia. Capital investment in Asia tends to be much more long-term. When a Japanese bank buys shares in a company, it is there for a long time. The pension fund managers in the States are just thinking of their quarterly earnings.

We really have to think more from the longer-term point of view, back to the old question: Where is long-term development finance going to come from? One of the legacies of the 1980s is to say: 'Government failure, forget about public flows, leave it to the market'. We left it to the market, you got market failure. We discussed this crisis actually two and a half years ago in another Fondad conference in The Hague. Then I said it was a very good place to meet because Holland had been the scene of one of the first crises of modern capitalism, the tulip mania, at a time when there was no welfare state, no import substitution and none of the other evils that have apparently beset

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private enterprise, and yet it happened. So this Mexican crisis is quite a serious turning point for Latin America, which gives us a lot to think about."

Compensatory Mechanism

Griffith-Jones' plea for the establishment of a compensatory mechanism provoked an interesting discussion about the nature and the targeting of such a mechanism if it were to be applied in Latin America's economic integration process.

Ricardo Ffrench-Davis observed that the crucial point of a compensatory mechanism would be at what exactly it should be directed. He thought it should mainly help to complete markets and increase the productivity of the poorer countries. "Trade within Latin America – of goods and services – is less than it ought to be given the geographical vicinity because we have incomplete markets. We have more complete markets between Latin America and the US or Latin America and Europe than, for example, between Bolivia and Paraguay, Peru and Chile, etc. The last two or three years we have been working on either completing or creating markets where they did not exist, and I would prefer the compensatory mechanism to be geared in that direction instead of being merely a mechanism to transfer money (which might just disappear in the deficit of the current account)."

Robert Devlin, a US national who heads the Integration, Trade and Hemispheric Issues Division of the Inter-American Development Bank, entirely agreed with Barbara Stallings that the US had shown no disposition to get involved in the establishment of a compensatory mechanism. However, Devlin thought the US ultimately was a very pragmatic place and might in future change its mind. "Just because there is a negative predisposition vis-à-vis compensation today does not mean it will always be like that. I think one has to – both at the political and the technical level – continue to talk about it and not just accept the status quo. My own personal belief is that if integration is going to succeed it will need compensatory mechanisms. Indeed, if it succeeds it will create demands for compensatory mechanisms. In fact we see that a little bit in Mexico today. The rescue of the Mexican peso came as a de facto result of the integration between the US and Mexico. The issue of compensation adjustment is a key one: it is both necessary to push integration forward and it becomes a necessary product of successful integration agreements as they move along."

Hector Assael noted that the case of Mexico was more like the kind of compensatory financing given by the IMF when a country faces balance of payments problems and had nothing to do with integration problems. "That is why the IMF could come in and put 17 billion dollars over there, not because of integration," Assael stressed. He therefore suggested that the

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concept of compensatory financing should be elaborated in more detail. "What are we really talking about? Both the IMF and the World Bank have compensatory financing mechanisms, but I don't think that's what we have in mind, because these are not related to resolving integration problems. The first approach which does relate to the resolving of these problems is the provision of compensatory financing to less developed *countries* that have trouble because of regional integration. For instance, you can give special treatment to Paraguay, or Bolivia, or Haiti. The second approach would be that we give a special compensatory treatment to less developed *regions* inside the member countries of the region – which is a little nearer to the European scheme. Third, we can think of – as Ricardo suggested – some specific sectors. For instance, if we have trouble with transport, with tourism or services, we give special support to those *sectors*. So, we need to explore what terms we are thinking in when we speak about compensatory financing for integration."

In this context, Percy Mistry suggested it might be useful to dwell for a moment on the unique range of regional compensatory arrangements established by the European Union (EU). According to Mistry, the EU has basically four categories of compensatory arrangements to remedy integration shocks.

- The first is to cover the costs of dislocation caused by integration. "Invariably, when you integrate you enlarge market size, you permit firms to operate across borders. Some firms will go under, some will survive, some will have to reinvest, some will have to develop new marketing capabilities. So you establish compensatory arrangements which can either benefit countries who make a case that their industries are being hit, or industries who make the case that they are going to be hit".
- The second category is directed at reducing regional imbalances. "This has become a boondoggle with the Mezzogiorno, Northern Ireland, Portugal and Spain. What was supposed to be a mechanism to reduce regional imbalances has become an effort on the part of the EU to buy support for the Community. Some of this has just confused the plain development financing, much of which the private sector could do. But the private sector is very happy to take government money especially when it is provided cheap. So I think one has to deal with this issue of regional imbalance reduction very carefully if one is contemplating these kinds of arrangements in Latin America. How much is really necessary? This is a damned difficult calculation to make".
- The third category is to compensate poorer outsiders (developing countries) for trade diversion effects. "This is what part of the ACP programme is all about, but the compensation is roughly 1 ECU for every 10 ECUs' worth of damage done. It is more a palliative than real compensation".

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- The fourth category is to support industries which are affected by integration. "Here you give compensation when it is clear that massive upgrading is needed to restore competitiveness in the steel industry or in the coal industry or in the textile industry, or you give compensation when a coal mine has to close down".

Augusto Aninat observed that the case of the European Community is very different from the Latin American experience, for while the member countries of the EU have resources in common and have the obligation to administer them, the Latin American countries do not have common resources and would first have to create them. Aninat thought that the first thing Latin America should do towards establishing an intelligent and efficient compensatory mechanism is to link the granting of such support to efforts at readjusting the economy or certain production sectors of the member country concerned.

Macroeconomic Policy Convergence

Most participants seemed to agree on the importance of policy convergence. Robert Devlin, however, added some critical remarks.

"I think there is an interesting dynamic developing. Mohamed El-Erian pointed out that there are criteria of convergence for entrance into the European Community and that these might have lessons for Latin America. Yet at the same time one has to take into account that the criteria of convergence have become strong when the European Community has reached the point where they do most of the trade among themselves. When they were integrating in the earlier stages, there were quite a few members in macroeconomic disequilibrium. France is probably a good example. It was not until the *franc forte* came along that France achieved macroeconomic equilibrium. Before that it had one macroeconomic problem after another. If we look at Europe, it is important not to look at Europe today, but to go back and look at Europe in its earlier stages and see what lessons can be drawn from that experience.

Second, perhaps Roberto Bouzas' comment remains valid that even with macroeconomic disequilibria there are a lot of things that you can do to promote integration. We have to remember that in Latin America intra-regional trade is still a relatively small part of total trade. The main trade partner for Latin American countries remains without any doubt the rest of the world. So it may not always be convenient to look for convergence with your Latin American partners when most of your trade is being done outside of your integration scheme.

I don't have any clear answer on this, but I think this is an area where we

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have to do more thinking. It is not a clear-cut black and white case of 'convergence, convergence, convergence', which you hear quite a bit. On the other hand, one doesn't want to be associated with promoting macroeconomic disequilibrium.

It seems to me that, in the initial stages of the integration that we have in Latin America, it is in the grey area where much of this falls.

There is another issue too: one has to be careful about how you converge. Part of what occurred in the Mexican case was because of convergence. There was a strong desire to converge with the US rates of inflation as quickly as possible. In order to achieve this, the exchange rate policy chosen was one of a nominal anchor, or semi-nominal anchor, and there were clearly problems with that. So again, it is not only a question of convergence but also a question of how you do it. Within our own profession there is a lot of disagreement on how you should go about it.

I don't have an answer, but I think there are a lot of questions which remain to be answered in this particular issue at these early stages of integration in Latin America."

Reply by Stephany Griffith-Jones

"I will try and address just some of the many issues that you all have raised and will concentrate on the comments made by the official discussants because I have had more time to think about them. Mohamed El-Erian and a number of people raised the issue of macroeconomic convergence. I think this is a very important issue today, particularly in the context of integration which includes such a strong element of financial integration and where you have short-term capital flows making macroeconomic coordination both more essential – because mistakes are punished very quickly – and much more difficult. Even in the case of the European Union, which is much more advanced in the integration process than anything we have in the Western Hemisphere, macroeconomic convergence has been very difficult, as we can – see from the break-up of the ERM and the need to broaden the bands both as a result of wrong macroeconomic policies in some countries – but not in others – and of massive surges of private capital flows. This is an issue which is even more difficult to handle in the Western Hemisphere.

The other issue that Mohamed raised is the issue of harmonisation of supervision and regulation. Indeed, this is a very important issue. And again, I think there are interesting lessons to be learned from the European experience, where there have been very long and very intense debates on how to integrate European financial markets, both in the banking sector and in the security sector. One of the lessons one can draw from the European debates is that the integration of supervisory regulation should be done as soon as possible, before the markets begin to be more developed. The more developed financial markets are and the more they have developed along different lines, the more difficult it becomes to harmonise them. There have been tremendous fights within Europe on apparently very technical issues like the level of transparency in stock exchanges, but they have to do a lot with harmonising financial sectors which are very different institutionally – you have, for example, universal banks versus banks which have more limited roles – and where you have very different philosophies of regulation. In the UK, for example, the emphasis is more on competitiveness of the financial sector and how to enhance that competitiveness, while the French and the Germans are much more concerned with market safety and avoiding financial distress and financial crisis. So you see from the European experience that there is an urgency to start soon with the harmonisation of supervision and regulation.

Next is the issue of compensatory mechanisms, to which I just devoted a little paragraph. It raised a number of issues. Barbara Stallings started the discussion by recollecting a session we had with Ron Brown here in Santiago. The question that she very clearly addressed to him, and which he very clearly answered, is that the US would be unwilling to do anything in this field. But the point I was trying to make is that it is not surprising that the US is unwilling because they would have to put either all of the money or 90 per cent of the money. The Germans were unwilling to put the money in 1956 too. But the point is that the Italians pressed them, saying they would only join if there was a European Investment Bank. And when the Spanish joined and the Portuguese joined, they also put almost as a condition of entry that compensatory mechanisms were created. There was a big fight, the Germans didn't just say 'OK, we'll sign the cheque'. In the end it was agreed that, as a condition of market access, some compensatory finance would be given to particularly the poorer areas that were affected by trade disruptions – but not just to the poorer areas, because the so-called 'senile' industries (for example, old steel plants), in the relatively richer countries like Britain or Luxembourg, also benefitted. If these industries were unable to adapt, they also received financial help to restructure.

All this is much more difficult in the context of Western Hemispheric integration because we have countries with very different levels of income and the majority of the countries are much poorer and so there are big issues of where the money would come from and go to. I think one possible way forward is to expand some of the compensatory mechanisms which – as was mentioned here – already exist in the context of the Caribbean Development Bank and on a much larger scale in the context of the Inter-American Development Bank. But to be realistic, we have to realise that these mechanisms, at least in the context of the IDB, have actually been decreasing.

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The volume of flows going at a subsidised rate to the poorest countries has been decreasing in the IDB quite sharply, particularly because the IDB doesn't have resources to fund it. The money has been far better targeted: it really goes now to the poorest countries, but there is very little of it. One possible way forward could be, as there is already an institution which exists and a mechanism which exists, to perhaps expand that and perhaps broaden it to the effects of integration. I am just thinking aloud.

The idea of Ricardo Ffrench-Davis to complete markets is very powerful and is consistent with what has been done in the European Union where the argument was, 'there are market imperfections'. These imperfections are particularly strong in the poorest countries. It is much easier to fund infrastructure in German or in Britain than in Portugal. Therefore it is more justified to give a loan from the European Investment Bank – a public fund – or to give some kind of guarantee for building a road or for funding small or medium enterprises in Portugal than it is in Germany or the UK. That is the line that has been taken and I think it works relatively well.

That brings me to a fourth point, which is the link between private and public sector funding. Again, I think there are interesting experiments going on in the European Union to fund intra-national projects of a very large magnitude in integration, not just roads or railways which involve massive costs, but also telecommunications and so on, which are now so crucial. It is the preference of EU governments, and the preference in general today of governments, to do this through the private sector, but the problem is that the private sector is sometimes unwilling to go into risky projects. So there is a search within the European Union for an intermediate package through creating a sort of guarantee facility which protects mainly against the specific risks which are borne by the private sector when it is involved in an intra-national project. For instance, you have to harmonise environment regulation, safety regulation and you don't know how this will affect your future profitability. We don't know yet how this guarantee facility – a 3 billion ECU facility has just been created – will work, but it should involve much less public funding than either if the government fully funded the facility or provided completely blank guarantees. To be clear, this facility will not guarantee against conventional commercial risks, it will only guarantee against risks of integration.

Finally, I would like to say that you raised a number of interesting issues that were not in my paper, for example the integration of stock exchanges and so on. This will be useful for our next meetings when we look at regional integration in other parts of the world."

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Trends in Regional Cooperation in Latin America: the Crucial Role of Intra-Regional Trade

Ricardo Ffrench-Davis

A significant upsurge has taken place in reciprocal trade within Latin America during the 1990s. In fact, total intra-regional exports of Latin America doubled in the four years 1990-94. By 1994 reciprocal trade covered 22% of total exports of goods, capturing nearly two-thirds of the increase in exports of the region between 1990 and 1994. If attention is focused on manufactures, both growth and shares are notably higher; actually, intra-regional exports are more intensive in manufactures and in non-traditional products. In this sense, regional integration contributes to a more dynamic productive transformation of the domestic economies, and can contribute to complement policies directed to enhance systemic productivity.

This paper focuses on the efforts made by Latin America to foster trade within the region, and on the results achieved. Section I presents a brief survey of economic integration between 1960 and 1990, passing through the swings experienced. Section II presents the framework of our analysis. First, the empirical scenario is discussed, giving an account particularly of trade reforms implemented recently in the region. Then the analytical framework is examined, placing the discussion in a globalising world, but with both limitations to access and to production of non-traditional and manufactured exports. These products face distortions and "incomplete" markets that regional cooperation can contribute to remove progressively and efficiently. It is stressed that regional cooperation is significant for these products rather than for traditional exports, for which world markets will remain the main source of sales. Section III examines the evolution of reciprocal exports in the 1990s. It is shown that actually intra-regional exports are more intensive in technology and value-added. Thus they exhibit more linkages with the domestic economy than traditional exports. Section IV discusses some of the pending or omitted issues relating to reciprocal trade.

I Intra-Latin American Trade and Economic Integration: A Brief Historical Account

During the 1960s, ambitious attempts were launched in Latin America to

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integrate the regional markets. They resulted from a growing awareness that import-substituting industrialisation was beginning to be seriously constrained by the size of domestic markets. Economic integration was considered to be an essential component of proposals for Latin American industrialisation.[1]

Economic integration passed through three distinct stages. The first (the 1960s and early 1970s) was characterised by extensive state intervention, timetables for the gradual elimination of intra-regional trade barriers, and movements towards the establishment of common external tariffs. Subsequently, by the late 1970s, frustration with the growing gap between the high initial expectations and the actual achievements of the first phase of integration brought on a period of passivity and consolidation. During this second stage, Latin American and Caribbean countries (LACs), shocked by the debt crisis, abandoned their earlier targets and adopted a cautious approach, based primarily on bilateral trade agreements with a partial scope. The onset of the third stage, the new wave of regional integration in the early 1990s, was concurrent with the transformation of trade and industrialisation policies. It was no longer viewed as a stimulus for import substituting industrialisation and as an instrument of "collective defence" of Latin American markets from foreign competition; instead, closer cooperation was seen as a lever to boost Latin American exports to world markets. The different approaches are reflected in the notably different levels of external tariffs as well as of margins of preference.

The first stage of integration policy consisted of three separate attempts in Latin America and one in the Caribbean to form regional trade organisations. These organisations together included most LACs and 95% of the region's population, GDP and trade. In 1960 the Central American Common Market (CACM) agreement was signed; it included El Salvador, Guatemala, Honduras, Nicaragua and Costa Rica (that joined in 1963). In the same year, the Latin American Free Trade Association (LAFTA) was formed; this was the largest of the region's groupings and came to include all Hispanic South America, Brazil and Mexico. In 1969, Bolivia, Colombia, Chile, Ecuador and Peru (with Venezuela joining four years later) established the Andean Common Market (ANCOM); its members continued to form part of LAFTA. In turn, the Caribbean countries formed the Caribbean Free Trade Area (CARIFTA), later replaced by the more ambitious Caribbean Community (CARICOM). Table 1 shows the relative importance in terms of population, GDP and trade of each of these groupings.

The momentum gained by the initial surge of activity in the 1960s was weakened subsequently by domestic political setbacks and the economic

1 See Prebisch, 1959; Sunkel, 1993.

Table 1 **Latin American and Caribbean Common Markets: Population, GDP, GDP per Capita and Imports, 1960-90**

	Population (millions)				Gross Domestic Product (at 1980 constant billions of $)				GDP per capita (at 1980 constant $)				Imports[h] (at 1980 constant millions of $)			
	1960	**1970**	**1980**	**1990**	**1960**	**1970**	**1980**	**1990**	**1960**	**1970**	**1980**	**1990**	**1960**	**1970**	**1980**	**1990**
1. Latin American Free Trade Association (LAFTA)[a]	183.0	240.5	306.4	375.0	234.0	405.8	702.5	794.5	1,279	1,687	2,293	2,119	27,310	38,572	80,124	80,395
2. Andean Group[b]	41.2	55.5	72.3	90.2	54.5	92.4	130.5	147.4	1,323	1,667	1,807	1,633	8,151	10,821	21,066	17,406
3. Mercosur	97.6	125.0	155.5	188.4	121.9	201.1	370.3	405.8	1,249	1,609	2,382	2,153	12,587	17,677	34,693	27,073
4. Central American Common Market (CACM)[c]	11.2	15.2	20.1	26.0	7.1	12.6	19.4	21.3	638	830	967	822	1,694	3,372	5,502	6,056
5. Caribbean Community (CARICOM)[d]	3.2	3.8	4.2	4.7		7.7	9.8	9.3		2,035	2,329	1,993	1,876	3,424	3,695	3,400[e]
6. Others[f]	8.1	10.4	13.0	16.0	3.7	6.3	11.3	13.4	457	599	869	837	905	2,312	4,833	4,768
TOTAL[g]	**202.2**	**266.2**	**339.5**	**416.9**	**244.9**	**424.7**	**733.3**	**829.2**	**1,211**	**1,595**	**2,160**	**1,989**	**29,908**	**44,256**	**90,459**	**91,220**

Notes: *a* Argentina, Brazil, Chile, Mexico, Paraguay, Uruguay and the Andean Countries (in 1980 LAFTA became LAIA (Latin American Integration Area)).
b Bolivia, Colombia, Ecuador, Peru and Venezuela.
c Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua.
d Barbados, Guyana, Jamaica and Trinidad and Tobago.
e Approximate value.
f Includes only Dominican Republic, Haiti and Panama.
g Because of lack of comparable date, it excludes Cuba and the Caribbean Community.
h Includes both imports of goods from group partners and from the rest of the world.

Sources: ECLAC, "Statistical Yearbook for Latin America", various issues, and ECLAC database.

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shocks of the 1970s. Military coups in Brazil and Argentina disturbed the progress of LAFTA; similarly, the violent military takeover in Chile in 1973 placed serious obstacles in the path of the Andean Group. On the economic front, the 1973 oil crisis drove a wedge between oil exporters – such as Ecuador, Mexico and Venezuela – and most of their common market partners. Oil exporters, facing an abundance of foreign exchange and a contraction of their non-oil tradeable sector (the so-called "Dutch disease"), found it increasingly difficult to produce non-oil exports for their regional partners. At the same time, all countries in the region took advantage of easy access to cheap foreign loans during the second half of the 1970s, thereby reducing the need to earn foreign exchange through exports. The 1982 debt crisis also worked against the expansion of regional trade, as countries set up across-the-board import restrictions to save foreign exchange and dramatically reduced aggregate demand.

Despite these problems and the ups and downs, economic interdependence did in fact grow substantially from its low initial levels of the 1950s. Economic integration arrangements had a positive effect on regional trade, especially in manufactured goods.

LAFTA and Subregional Groupings

The Treaty of Montevideo which was signed in 1960 by seven LACs (despite strong US reservations) led to the establishment of LAFTA. LAFTA members, which subsequently increased to eleven nations, were to eliminate tariffs and other trade restrictions gradually in twelve annual rounds of negotiations, working within the general rules of GATT regulating economic integration agreements.

Considerable progress was made towards the elimination of trade barriers over the course of the first three annual rounds of negotiations. Following this brief period of success, however, negotiations stalled. The stalemate was attributable to three main features: (a) shortcomings within the Treaty of Montevideo itself; (b) lack of political will among several key member countries; and (c) antagonism to trade liberalisation by import substituters seeking to maintain monopolistic control over domestic markets.

First, the Treaty failed to include effective mechanisms to reduce internal tariffs and to bring about a common external tariff. Second, the Treaty lacked adequate measures to achieve an equitable distribution of benefits among member countries. Finally, insufficient attention was paid to harmonising economic policies among participants.

However, innovative financial arrangements and the so-called Complementary Agreements did allow significant progress in financial and trade agreements from the mid-1960s onwards. The Agreement on Multilateral

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Settlements and Reciprocal Credits, including all LAFTA countries and the Dominican Republic, was established by the central banks of the member countries in 1965. It aimed to foster a direct relationship between Latin American commercial banks, in order to avoid having to use external financial intermediaries in their reciprocal dealings; it was also intended to improve credit availability for reciprocal trade in countries with balance of payments problems. Initially, two-thirds of reciprocal trade was settled under this multilateral payment system, a figure which reached over 80% by 1980. An important result of this financial mechanism was the growing interconnection among local banks and the encouragement to reciprocal trade resulting from credit availability.

In the Complementary Agreements, two or more member countries could agree to liberalise trade of a specific group of commodities and establish other mechanisms to foster reciprocal trade. The Complementary Agreements took place mainly in sectors in which output was diversified within the (mostly transnational) firms, making intra-firm specialisation feasible. After 1964 most of the limited additional liberalisation that took place was implemented via new Complementary Agreements. By 1970 eighteen Agreements had been signed, all relating to manufactured goods.

Despite the loss of momentum after 1964, LAFTA persevered, even managing some additional tariff reductions at annual negotiation rounds. Indeed, despite all the problems, the share of intra-LAFTA trade in total trade of member nations nearly doubled between 1962-4 (7.6%) and 1979-81 (13.7%).

The continued increase in intra-LAFTA trade can be traced to four factors. First, there was a lag between the adoption of tariff preferences and their use by exporting countries, as market channels needed to be established, product designs adjusted, production bottle-necks overcome and information made available on regional trade opportunities. Second, the financial arrangements initiated in 1965 facilitated an increase in reciprocal trade. Third, the improvements in access to information, marketing and financial channels benefited all intra-LAFTA trade, including products not covered by tariff preferences. Fourth, trade among members of the Andean Pact (whose figures are included in LAFTA Trade), grew particularly quickly immediately after the creation of this group in 1969.

With the LAFTA experience behind them, participants in the Cartagena Agreement incorporated institutional arrangements which they considered more effective than those established under the Montevideo Treaty. First, provision was made for an executive body (Junta del Acuerdo de Cartagena) with some supranational powers. Second, the new treaty set out a clear schedule for trade liberalisation, including the gradual establishment of common external tariffs. Third, a system was designed to achieve an equitable distribution of benefits, comprising both sectoral programmes for industrial development and tariff preferences for the least developed members, Bolivia and Ecuador.

The Cartagena Agreement established that internal tariffs of about two-thirds of products were to be reduced by 10% per year, and phased out altogether by 1981.[2] However, this schedule was repeatedly delayed. Nonetheless, by 1979 the maximum internal tariff applied by Colombia, Peru and Venezuela to reciprocal trade of that large group of items was 32%, while the average tariff was 14% (only one-third of the 1969 value). The overall trade impact of the Andean Common Market agreement was largely positive during the 1970s. Intra-Pact exports of manufactures increased at an annual rate of 24%, while manufactured exports to third countries grew by a respectable 14%. By 1980 the Andean market absorbed 36% of all manufactured exports by member countries.[3]

As shown in table 2, an important feature of the growth of intra-LAFTA trade was the rapid increase of the share of manufactures – from 11% of total regional trade in 1960 to 46% in 1980.[4] The growth of manufactured exports to LAFTA partners was particularly strong in Argentina, Brazil and Mexico.[5] In Brazil, for example, exports of manufactures to LAFTA countries comprised 80% of its total intra-LAFTA exports in 1980, more than double the share of manufactures in total Brazilian exports.

To sum up, although LAFTA's achievements fell far short of the goals set out in the original Montevideo Treaty, the agreement did in fact contribute significantly to the expansion of intra-regional trade. The most outstanding gains were scored in the manufacturing sector, as LAFTA aided regional producers in their efforts to secure markets, increase capacity utilisation and use of economies of scale, and foster some investment.

The Central American Common Market (CACM)

Trade within the Central American Common Market (CACM) also rose rapidly in the 1960s. The CACM achieved a broad liberalisation of reciprocal trade and a common external tariff, with the share of intra-CACM exports reaching 28% of total exports and 96% of total manufactured exports in

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2 Intra-Andean trade was to be liberalised based on four categories, with separate tariff-reduction mechanisms for each category. Tariffs were immediately abolished on goods not produced within the Pact, and on goods included in the first tranche of the LAFTA common list.

3 Ffrench-Davis, Muñoz and Palma, 1994.

4 Between 1960 and 1980, manufactures rose from 13% to 47% of total intra-Latin American exports. This shift towards rising shares for manufactures took place despite the fact that food and raw material exports increased at a rather high rate of 5% per annum from 1965 to 1980.

5 The figure for Mexico decreases after the large rise in oil exports towards the end of the 1970s.

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Table 2 LAFTA (LAIA) and CACM: Shares of Manufactures in Total and Intra-Regional Trade, 1960-90
(percentages calculated on the basis of current dollars)

	1960		1970		1980		1990	
	Total Mfg exp./ Total Exports (1)	Intra-reg. Mfg exp./ Intra-reg. Exports (2)	Total Mfg exp./ Total Exports (3)	Intra-reg.Mfg exp./ Intra-reg. Exports (4)	Total Mfg exp./ Total Exports (5)	Intra-reg. Mfg exp/ Intra-reg. Exports (6)	Total Mfg exp./ Total Exports (7)	Intra-reg. Mfg exp/ Intra-reg. Exports (8)
LAFTA (LAIA)	3.4	10.6	9.8	33.4	17.3	46.1	33.0	51.3
Argentina	4.1	6.6	13.9	33.0	23.1	43.7	29.1	45.3
Brazil	2.2	8.4	13.4	47.3	37.1	79.9	51.9	82.9
Mexico	15.7	65.6	33.3	75.4	12.1	50.2	43.3	75.9
CACM	3.7	26.3	21.2	74.5	23.8	77.2	23.1	69.8
LATIN AMERICA[a]	3.4	12.6	11.5	40.5	17.9	47.3	33.1	52.6

Note: [a] Excludes Cuba and the Caribbean countries.
Sources: Column 1, ECLAC, "Statistical Yearbook for Latin America", Santiago de Chile, various issues.
Column 2, ECLAC, "Dirección y Estructura del Comercio Latinoamericano", Santiago de Chile, 1984.
Columns 3 to 8, United Nations Statistical Information System, COMTRADE databank.

1970. Thus, progress in trade was much more significant in the CACM than in LAFTA.

Since industrialisation took place for the most part simultaneously with the integration process, vested interests grew as a force in favour of intra-regional trade. It was a case of integration-led import substituting industrialisation. Contrariwise, in LAFTA, the efforts to foster intra-regional trade in many cases were defeated by the vested interests built up during the earlier national phase of import substituting industrialisation between the 1930s and 1950s.

Drop of Reciprocal Trade in the 1980s

By the 1970s it had become apparent that economic integration, despite significant achievements, had failed to fulfil its early promise. Conflicts of interests, economic policy instability within the countries of the region, external pressures, and shortsighted domestic industrial groups, had all been growing obstacles to the process of integration. Furthermore, for governments embarking on the neo-liberal experiments of the 1970s and 1980s, particularly in the Southern Cone, Integration came to be seen as another form of protectionism, and was therefore rejected from an ideological point of view.

Although total and intra-regional exports continued to rise until 1981, the debt crisis of 1982 led to a sharp decline in reciprocal trade during the 1980s. For example, in current prices, the 1985-6 level of intra-Latin American exports was less than two-thirds of the 1981 level (US$10.4 billion and US$16.8 billion, respectively). Also, in 1986 intra-Andean exports were just over one-half the 1980 level, with intra-CACM trade falling by two-thirds. Overall, the ratio of regional to total exports returned to levels similar to those of the late 1960s.

A major factor in the decrease in intra-regional exports was the steep decline in import capacity throughout the region associated with the debt crisis. Contraction of domestic demand caused a generalised reduction of imports. Import restrictions, including goods from regional trading partners, were reintroduced as a means of saving scarce foreign exchange. Naturally, intra-regional exports are equal to intra-regional imports. In addition, large-scale currency devaluations in most Latin American countries meant that relative prices among them remained broadly stable, while exchange-rate realignment with the industrial countries reduced the relative costs of Latin American exports outside the region, contributing to an increase in the volume of extra-regional exports.[6] In nominal terms, manufactured exports to

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6 In macroeconomic terms, aggregate demand, including all imports, was reduced. Output also experienced a drop, but exports to the rest of the world increased. The production of non-tradeables and of reciprocal exportables fell.

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non-Latin American countries rose by two-thirds between 1980 and 1985, while those to the region fell by over one-third during the same period.

During the economic downturn of the 1970s in the industrial countries, regional trade had performed as an anti-cyclical adjustment mechanism, as exports were redirected to Latin American trading partners. In contrast, in the 1980s, however, LACs endeavoured to reduce imports from all sources, but more intensively those from within the region. This must be viewed as a missed opportunity, since intra-regional trade could have provided expanded export outlets; this could have permitted higher levels of capacity utilisation, particularly in manufactures, thus reducing the heavy costs of adjustment in the 1980s.[7]

This period also saw a reassessment of the entire integration project. Fixed targets for trade liberalisation, regional planning and coordination of direct foreign investment policies were rejected in favour of a more flexible approach to integration, expressed in bilateral agreements with a partial scope. The new Montevideo Treaty of 1980 (in which LAFTA was renamed LAIA, the Latin American Integration Agreement) reflected this atmosphere. In this respect, it is significant that this change occurred before the 1982 debt crisis, that is, because of pessimism regarding the role and potentialities of economic integration, and of drastic changes in economic ideology. In turn, in 1987 the Andean countries joined the Quito Protocol, which revised their integration schedule. Despite the decline in Andean Pact trade, some aspects of the liberalisation programme were continued.

The Montevideo Treaty II, of 1980, was an attempt to salvage some of the trade gains of integration on the basis of bilateral agreements. Of the US$2.2 billion of intra-regional imports covered by trade preferences by 1984, 84% were carried out under bilateral agreements. Another feature of the new LAIA grouping was the endorsement of bilateral agreements with countries from outside the scheme. Mexico, for example, signed bilateral accords (including non-reciprocal tariff and non-tariff preferences) with Costa Rica, Cuba, Nicaragua and Panama. Argentina, Colombia and Venezuela entered similar agreements with several Central American countries.

In Central America continued political tension between the Sandinista government in Nicaragua and the US-supported regimes in Honduras and El Salvador made it particularly difficult to produce a new CACM treaty. The increase in political tensions posed obstacles to CACM regional trade. However, the debt crisis was the main discouraging factor. In this sense, Central America faced in the 1980s a similar type of problem to the rest of Latin America. The sharp recession discouraged reciprocal trade more

7 Ffrench-Davis, Muñoz and Palma, 1995.

intensively than that with extra-regional markets. Given the large share that manufactures had captured in intra-regional exports, the manufacturing sector suffered a significant impact with the drop of reciprocal trade. In addition, declining international prices for the region's commodity exports, and the general overvaluation of CACM currencies, generated increased pressure for protection. During the 1980s import barriers were raised and bilateral agreements replaced CACM mechanisms. Eventually, nonetheless, political obstacles were overcome, and a presidential summit in 1990 launched a new integration agreement, the *Comunidad Económica Centro-americana*. The main objectives of this new scheme were to preserve earlier gains and to proceed via bilateral agreements.

The most outstanding bilateral agreement of the 1980s was the Argentina-Brazil accord of July 1986, covering issues as varied as the renegotiation of tariff preferences, binational firms, investment funds, bio-technology, economic research and nuclear cooperation. Of the sixteen protocols signed, the most significant was the first, that dealt with the production, trade and technological development of capital goods. This bilateral agreement gave birth in 1991 to Mercosur, when Paraguay and Uruguay became members of the process.

Quite another form of economic integration was the Caribbean Basin Initiative, launched by the Reagan administration. Its beneficiaries were Costa Rica, Honduras, El Salvador, Guatemala, Panama and the Caribbean region (except Guyana and Cuba). This agreement provided for duty-free access to the US market (excluding textiles, garments, footwear, leather apparel, work gloves, canned tuna, oil products, watches and watch parts) for twelve years. Sugar, however, a major commodity export from the Caribbean, remained subject to import quotas. To qualify, goods must be exported directly to the US and have a minimum domestic value added of 35%. Costa Rica and the Dominican Republic benefited most from investments encouraged by the new scheme, as capital moved into the electronic, fisheries, wood and furniture industries, as well as some non-traditional agricultural products such as strawberries, melons and cut flowers.

A more ambitious proposal was put forward by the Bush administration in 1990. Presented as the US President's "Initiative of the Americas", its stated objective was the creation of a free-trade zone stretching from the Port of Anchorage to Patagonia. The first step towards this objective was the establishment of a free trade zone including Canada, the US and Mexico – the North American Free Trade Agreement, NAFTA – intended to encompass all Latin America at some unspecified future date.

The Bush administration's proposal represented a complete reversal of the initial motivation for integration in the 1950s. Economic integration was then envisaged both as an essential stimulus to import substituting industrialisation and as a creative defence against US economic superiority, and was therefore opposed by that country (with the exception of the Alliance for Progress period).

Over a period of three decades LACs had launched a varied range of initiatives to achieve economic integration. Several efforts achieved some degree of initial success, but stalled in the later stages of negotiations, as they moved into areas where conflicts of interest were more pronounced. With the benefit of hindsight, it is apparent that many of the goals set out in the original agreements were overly ambitious and in some cases economically and politically naive. The inability of the various groupings to meet their objectives undoubtedly damaged the credibility of the entire integration project, and generated frustrations which hampered attempts to achieve more practical goals.

Another major problem was that the larger, more developed countries did not do enough to dispel doubts among the smaller and poorer countries that the benefits of increased regional trade would be shared by all member countries. Domestic political and economic obstacles were also important. In many countries, domestic producers were reluctant to surrender quasi-monopolistic control over local markets.

The lack of commercial, financial and infrastructural ties existing prior to these efforts did not augur well for the kind of rapid, comprehensive integration sought under the various agreements. In addition, the emphasis on tariff reduction as the principal mechanism of integration was misplaced when non-tariff obstacles accounted for a large share of trade barriers.

Despite these problems, some important gains were made. Until the 1980s crisis, intra-regional exports had doubled as a share of total Latin American exports. Achievements were more substantial in the CACM than in the Andean Pact and LAFTA; but even in the latter two, intra-regional trade expanded significantly, allowing for some specialisation and increasing rates of capacity utilisation. Furthermore, the more dynamic export activities in intra-regional trade were those with larger domestic valueadded. However, its main setback was that it was unable to provide the essential "critical mass" market, expectations of sustainability, and the degree of competition required for it to succeed in the long run.

In the last analysis, the main obstacles to regional economic integration were the same ones that constrained economic development in general in Latin America during this period: lack of continuity in domestic economic policies, abrupt political changes, shortsightedness of entrepreneurial groups, over-ambitious expectations in designing agreements, several external shocks, and the foreign debt crisis.

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II The Analytical and Empirical Framework in the 1990s

The Empirical Scenario: Trade Liberalisation in Latin America

Trade reforms have been undertaken as part of a broad-ranging process of change in which international competitiveness and exports play a leading role. Most countries are searching for 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 liberalisation of imports.[8] The aim is to expose producers of importables, which have often been receiving a high level of protection, to outside competition, while also encouraging the output of exportables. It is expected that this will result in higher productivity, less inefficiency, the absorption of new technologies and increased specialisation. Producers that do not adapt to outside competition would be pushed out of the market, and the resources liberated by their displacement, supposedly, would be smoothly absorbed by other activities, primarily in the production of exportables. The latter would be encouraged by cheaper and more easily available imported inputs and by an expected exchange-rate devaluation.

Many countries in the region have undertaken such trade liberalisation reforms in recent years (see table 3). Most LACs introduced reforms that could be described as drastic and sudden. In fact, the liberalisation of imports was carried out within a period of just two or three years (1989-1990 to 1992-1993). In all cases, albeit to varying extents, quantitative restrictions were dismantled and tariffs lowered significantly.

Generally speaking, the tariff protection provided at present differs considerably from its pre-reform levels, and the spread of rates of effective protection has diminished substantially. No country has yet adopted a zero tariff rate, however, and only Chile has had a uniform tariff since 1979 (currently 11%). Bolivia is close to it, with two tariff brackets and a 10% maximum. Other countries have a number of different tariff rates, with ceilings ranging from 20% to 35%, and average rates of between 10% and 18%. These regional trends in trade policy have been complemented by a drive towards the conclusion of bilateral or multilateral free trade agreements covering a wide spectrum of items.[9] The fact that tariffs are different from

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8 Agosin and Ffrench-Davis, 1993.

9 Until June 1990, the mainstream opinion was that integration accords should be of a partial, very limited scope, along the lines of the Latin American Integration Association agreement in force at the time. The majority view was that trade blocs were inefficient and hindered world trade. President Bush's Enterprise for the Americas announced in June 1990 changed that view, however, and concerns about trade diversion now appear to have faded away.

Table 3 Latin America (Selected Countries): Summary of Unilateral Trade Liberalisation

Country	Programme starting date	Maximum tariff		Number of tariff rates		Average tariff		Non-tariff barriers	Variation in real exchange rate [a]
		Initially	Year-end	Initially	Year-end	Initially	Year-end		
Argentina[b]	1989	65	30		3	39[c]	15[c]	In 1988 the value of industrial production subject to restriction was reduced from 62% to 18%. In 1989-1991 non tariff restriction, temporary additional duties and specific duties were eliminated.	-49
Bolivia	1985	150	10		2	12[d]	7[d]	With few exceptions, all import bans and license requirements were abolished.	92
Brazil	1988	105	35	29	7	51[e]	14[e]	In 1990 the list of banned imports and prior-licencing requirements were eliminated. However, national-content requirements for intermediate and capital goods will be maintained.	44
Colombia[b]	1990	100	20	14	4	44[d]	12[d]	Nearly all restrictions concerning the prior-licencing requirement were lifted in late 1990.	-4
Costa Rica	1986	100	20		4	27[e]	14[e]	Import permits and other restrictions were phased out in 1990-1993.	10
Chile[f]	1973	220	10	57	1	94[e]	10[e]	In the 1970s quantitative limits on imports were eliminated.	-10
	1985	35	11	1	1	35[e]	11[e]	Price bands were re-introduced and an anti-dumping system was established.	32
Mexico	1985	100	20	10	3	24[c]	12[c]	The coverage of import permits was reduced from 92% of foreign purchases in June 1985 to 18% in December 1990, and official import prices were eliminated.	-15
Peru[b]	1990	108	25	56	2	66[e]	18[e]	Import licences, authorisations, as well as quotas and bans, were eliminated in September 1990.	-28
Venezuela	1989	135	20	41	4	35[d]	10[d]	The number of categories subject to restrictions was reduced from 2,200 in 1988 to 200 in 1993. Specific duties, which in some cases raised the maximum tariff to 940%, were abolished.	15

Notes: *a* From the year before the liberalisation programme began up to 1993; the exchange rate for exports has been used.
b Tariffs include surcharges.
c Weighted by domestic production.
d Weighted by imports; simple average for 1993 gives 9.7%.
e Simple average of tariff items.
f Chile's first trade liberalisation programme was completed in 1979. The uniform tariff of 10% remained in force until 1982. Thus, the information in the first row is for that period (1973-82). The second row contains information for 1985-93. Import tariffs, after rising to 35% in 1984, were successively reduced to 20% (1985), 15% (1988) and 11% (1991).

Source: ECLAC (1994b), table V.

zero but with moderate levels leaves space for reciprocal tariff preferences that imply more limited trade diversion than in earlier integration programmes.

In a number of countries, trade liberalisation has been accompanied by the liberalisation of the balance of payments capital account. Under the conditions prevailing in international capital markets since the start of the 1990s, when external financing began to flow to Latin American countries once again, the liberalisation of the capital account has prompted considerable exchange-rate appreciation,[10] just when trade reforms urgently required a depreciation. In fact, the majority of nations have revalued their currencies since 1990. An exchange-rate index (weighted by GDP) gives a revaluation of 25% between the average of 1987-90 and 1994. Some countries (like Chile and Colombia) have been more successful than others in countering appreciating pressures on their exchange rates; in order to do so, they had to resort to foreign exchange controls and other heterodox forms of "financial engineering".[11]

In general, import liberalisation has not been accompanied by other policies promoting the production of exportables, while public efforts to enhance systemic productivity have been rather isolated and weak.[12]

The Analytical Bases

From the point of view of development theory and policy, the standard approach to trade integration tends to rest on very weak assumptions. The conventional literature on 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 is how costs are measured. In the standard approach it is at present market prices net of tariffs, discounting transitional costs as well as acquirable competitivity. The assumptions lead to the obvious conclusion that overall unilateral liberalisation is the optimal national policy and so better than integration.

Why, then, do so many nations want to be involved in integration processes? In this context we will refer to five issues related to trade in goods and services.

10 Calvo, Leiderman and Reinhart, 1993; ECLAC, 1995, ch. XI; Ffrench-Davis, 1992.
11 See Devlin, Ffrench-Davis and Griffith Jones, 1995.
12 See the comprehensive discussion in ECLAC, 1995.

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First, world markets are not wide open and stable. Nonetheless, they are broad, particularly for trade in natural resources and semi-manufactured commodities. Actually, with or without participation in integration processes, world markets will continue to be crucial for traditional exports of LACs; instability prevails in those markets, but it refers more to prices than to access (of volume). However, for many non-traditional products, access to markets is more limited and unstable. It is for these type of products that regional integration becomes more relevant.

Second, given those distortions in world markets, economies of scale and specialisation are more difficult to secure. Improved access to foreign markets helps to make use of those economies, and in fact this achievement has been a leading force encouraging regional integration.

Third, factors markets are incomplete or distorted. Labour training, technology and long-term capital are scarce, with non-existent or infant markets and with significant externalities.[13] These domestic market failures are heavier for non-traditional exports, whether of natural resources, manufactures or services. If access to external markets is improved for these exportables, it can strengthen the efforts to complete markets and dilute segmentation.

Fourth, infrastructure, trade financing and knowledge of markets (marketing channels, organised transportation, standards, etc.) are biased against intra-regional trade in LDCs. All these "factors" of trade have been traditionally more developed for deals with the "centre", while they are non-existent or more rudimentary for trade among neighbouring LDCs. This is a significant variable explaining why intra-regional trade has been lower among LACs than what the gravity of geography would suggest.

Fifth, in economies that are reforming trade policies, sliding away from excessive and arbitrary protection to import substitutes and inputs of exportables, significant transitional costs tend to emerge. These are enhanced if the exchange rate happens to appreciate, as has been the case in most LACs in the 1990s.[14]

East Asian nations minimised transitional costs with an export-led strategy for opening to the world economy.[15] In fact, the path of adjustment was intensive in the positive pulls of increased output of exportables (characteristic of an export-led reform), vis-à-vis rather weak negative pulls of import de-substitution; strong negative pulls are more characteristic of an import-led reform. Given the LACs' option for the latter sort of trade reform, a parallel process of regional cooperation becomes more attractive, in order to increase

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13 ECLAC, 1995, ch. VII.
14 See Devlin, Ffrench-Davis and Griffith-Jones, 1995.
15 See Agosin and Ffrench-Davis, 1993.

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the efficiency of the productive transformation.[16] In fact, increased reciprocal imports are compensated with reciprocal exports. Thus, regional cooperation adds a compensatory ingredient to a given unilateral import liberalisation, fostering reciprocal exports in tandem with reciprocal imports. It is even more welcome if the exchange rate has appreciated in the process. Hence, the doses of positive and negative impulses to economic activity and investment are more balanced with regional cooperation than is the case in pure unilateral import liberalisation. As discussed below, the beneficial effects of fostering reciprocal trade in these circumstances have become evident in recent years.

III Trade Integration Agreements in the 1990s

Trade integration has been making great progress in the 1990s. On the one hand, trade and investment flows among the countries of the region have displayed extraordinary growth.[17] On the other, integration agreements among various groups of countries have proliferated. These second-generation agreements are very different from those inherited from the past. Already numbering more than thirty, they generally seek the effective liberalisation of most of the partners' trade within unusually short periods of time.

Various factors have helped to shape these new circumstances. They include the widespread return to democratic regimes, which has facilitated closer relations between countries; the gradual recovery from the most devastating effects of the debt crisis; and the liberalisation of economies in general and trade regimes in particular.

Proliferation of Trade Agreements

Two types of trade liberalisation agreements can be identified.[18] First, four subregional integration agreements are in operation: the Central American Common Market (CACM), the Cartagena Agreement, the Caribbean Community (CARICOM) and the Southern Common Market (Mercosur). Of these, Mercosur is the most recent, having been set up when Argentina, Brazil, Paraguay and Uruguay signed the Treaty of Asunción on March 1991. Second, about thirty geographically more limited agreements have been signed (see table 4), mostly in the context of the Latin American Integration Association (LAIA). Trade liberalisation commitments have been formalised

16 ECLAC, 1995b.
17 On reciprocal investment flows see Griffith-Jones' paper in this volume.
18 See ECLAC, 1994a, pp. 42-47.

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bilaterally or between groups of countries; for example, between the CACM countries and Mexico, between those countries and Colombia and Venezuela, and between CARICOM countries and Venezuela.

Table 4 Bilateral And Multilateral Agreements

Countries or agreements	Year Signed	Tariff Reduction on positive list products	Overall tariff reductions with exceptions
Argentina-Uruguay (ACE N° 1)	1982	X	
Brazil-Uruguay (ACE N° 2)	1882	X	
Chile-Uruguay (ACE N° 4)	1985	X	
Mexico-Uruguay (ACE N° 5)	1986	X[a]	X[a]
Argentina-Mexico (ACE N° 6)	1986	X	
Mexico-Peru (ACE N° 8)	1987	X	
Argentina-Peru (ACE N° 9)	1988	X	
Argentina-Colombia (ACE N° 11)	1988	X	
Argentina-Paraguay (ACE N° 13)	1989	X	
Argentina-Bolivia (ACE N° 19)	1989	X	
Argentina-Brazil (ACE N° 14)	1990		X
Bolivia-Uruguay (ACE N° 15)	1991	X	
Argentina-Chile (ACE N° 16)	1991	X	
Chile-Mexico (ACE N° 17)	1991		X
Argentina-Venezuela (ACE N° 20)	1992	X	
Argentina-Ecuador (ACE N° 21)	1993	X	
Bolivia-Chile (ACE N° 22)	1993	X	
Chile-Venezuela (ACE N° 23)	1993		X
Chile-Colombia (ACE N° 24)	1993	X	
Brazil-Peru (ACE N° 25)	1993	X	
Bolivia-Brazil (ACE N° 26)	1994	X	
Brazil-Venezuela (ACE N° 27)	1994	X	
Ecuador-Uruguay (ACE N° 28)	1994		X[b]
Bolivia-Paraguay (ACE N° 29)	1994	X	
Ecuador-Paraguay (ACE N° 30)	1994	X	
Bolivia-Mexico (ACE N° 31)	1994		X[c]
Chile-Ecuador (ACE N° 32)	1994		X
CARICOM-Venezuela	1992	X	
Central America-Mexico	1992		X[d]
Colombia and Venezuela-Central America	1993		X[d]
Colombia, Mexico and Venezuela (G-3)	1994		X
CARICOM-Colombia	1994	X	

Notes: *a* Uruguay has a positive list of Mexican products eligible for reduced import duties, whereas Mexico has a negative list of exceptions.
b The given preference consist in a reduction of 50% of the taxes applied to the imports from non-LAIA members countries.
c The available information would support the prediction that the tariff reduction would be slow but generalised with some exceptions.
d Asymmetrical preferences.
Source: ECLAC, on the basis of information of LAIA Secretariat.

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The common denominator of all these agreements is a preferential treatment in the form of increasingly lower duties on a list of goods targeted for internal trade liberalisation, maintaining tariffs to imports of those products from third countries.

A comparative analysis of the various integration agreements[19] shows that, since 1990, the relative importance of agreements that seek broader trade liberalisation has grown by contrast with the narrower trade agreements of the past. This can be seen in three areas: broadening of the range of products to which tariff reductions apply by focusing negotiations on lists of exceptions rather than on lists of products eligible for trade liberalisation; programmes directed to a complete and rapid phasing out of tariffs, rather than to reducing them; and intended removal of non-tariff barriers.

Many first-generation bilateral agreements[20] that use "positive" lists of products to be given preferential treatment are still in force. Moreover, a degree of fragmentation has occurred within some subregional groups, such as Central America or the countries of the Cartagena Agreement, which is reflected in bilateral or trilateral liberalisation agreements or in commitments with smaller geographical coverage than earlier subregional agreements. Mercosur, on the other hand, includes an ambitious commitment to extend free trade to all goods produced by member countries, while other subregional agreements operate with negative lists of exceptions.[21] In the case of Mercosur, member countries agreed to abolish, during the transitional phase, all tariffs and restrictions applied in their reciprocal trade. To this end, a programme of progressive, linear, automatic lifting of internal tariffs was applied according to a timetable which was fulfilled by the end of 1994.[22]

The countries of Mercosur will form an integrated market of 200 million people, or 45% of the Latin American population,[23] covering 59% of the region's land area, with a gross domestic product of nearly US$700 billion – 49% of the regional total – and US$62 billion on world exports. In other words, in its present dimension, Mercosur will create an integration space which accounts for roughly half the value of Latin America's main economic indicators, and which will therefore have unmistakable potential and drawing power.[24]

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19 See ECLAC, 1994a, tables II-6 and II-7

20 See ECLAC, 1994a, table II-5

21 See ECLAC, 1994a, table II-7

22 The trade liberalisation trend has recently been modified somewhat due to the growing external imbalances accumulating in several countries and the reconversion problems emerging in sensitive sectors.

23 In this context, Latin America is defined as the eleven member countries of LAIA, the six Central American countries, the Dominican Republic and Haiti.

24 See Bouzas, 1995a.

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Mercosur also has promising potential for expansion, eventually becoming a pole for convergence of the several moves toward Latin American trade integration. Actually, advanced negotiations are under way with Chile to put an association in motion, probably in the form of a free trade agreement. Talks have also been taking place with the Andean Pact, particularly Bolivia.

Bilateral agreements, unlike subregional schemes, generally do not provide for the adoption of common external tariffs. Three subregional agreements currently have agreed and implemented a common external tariff schedule to be applied by all members: Mercosur since January 1995, while the Andean Pact started in February 1995. The CACM has in effect a common external tariff approved by four of its member countries since mid-1993, although they apply many exceptions.

In the absence of common external tariffs, rules of origin of imported goods take on primary importance:[25] if different levels of protection apply, goods from non-member countries can be imported into a low-tariff country and then re-exported to other members of an integration scheme without paying duty. To avoid this distortion, bilateral agreements include commitments to adhere to the LAIA rules of origin, although most of these agreements, as well as subregional ones, envisage the possibility of formulating specific rules that do not necessarily reflect LAIA guidelines. The resulting possibility that a wide variety of rules will be adopted poses certain risks, since such rules could cause distortions in trade and in the allocation of investment.

Recent agreements tend to include greater sectoral commitments than the older bilateral agreements, although the relevant clauses establish commitments that are very different from the sectoral investment programmes launched under previous subregional processes, particularly the Cartagena Agreement and the Central American Common Market. A number of recent sectoral clauses are restrictive, imposing special rules of origin that are more stringent than those applied to other products that enjoy preferences.[26] This is true particularly of the automobile industry, but specific commitments involving more stringent rules or quantitative restrictions also exist in the cases of capital goods and natural gas. In other cases, sectors (including also services) are identified with generic commitments which would have to be made specific later.

Sectoral agreements concluded under wider schemes make special reference to certain services, particularly transport, in order to create opportunities for extending integration into new areas. Provisions on reciprocal investment protection and promotion take on crucial importance in such

25 See Garay and Estevadeondal, 1995.

26 See ECLAC, 1994b.

cases, as can be seen from recent bilateral agreements which pay more attention to the topic than subregional agreements.[27]

Lastly, recent integration agreements seem to have a more limited institutional framework than earlier ones. Bilateral agreements and Mercosur both provide for intergovernmental entities to supervise their application, but these entities are not secretariats or agencies like those established in previous subregional agreements. Differences are also apparent between the more formal dispute settlement mechanisms of older subregional agreements, especially the Court of Justice established under the Cartagena Agreement, and the more pragmatic provisions of newer integration agreements which generally foresee dispute panels.

In brief, there is a growing number of second-generation bilateral agreements spreading throughout the region. In general, they seek to liberalise trade in most items through lists of automatic tariff cuts to be implemented in a relatively short term. In this way, an increasingly intricate constellation of regional, subregional and bilateral preferences and regulations is being created, which will require careful and timely efforts towards their convergence in order to reap and consolidate the net benefits of regional integration.

Rising Intra-Regional Trade and Changed Composition

Total intra-regional exports more than doubled in current value between 1990 and 1994. Initially it was principally a recovery from the sharp drops of the 1980s. However, given a notably rapid growth, the prior peaks were soon reached. A new record was achieved in 1992, with an additional jump in 1993. The progress continued, although at a more moderate pace, in 1994, influenced by rising exports to Brazil, compensated by a drop in intra-regional exports to Argentina, and particularly to Venezuela. By 1994, 22% of the exports of goods of LACs were to regional markets (see table 5).

The rise in reciprocal trade and in total exports applies to most of the region, among CACM and Andean nations, as well as in Mercosur. Only the Caribbean countries display stagnation.

The profile of intra-regional exports reveals a drastic change in composition: the predominance of primary exports was replaced by manufactures, which now account for one-half of intra-trade. A quarter of trade is in semi-manufactures, which have not changed their relative importance. The notable increase in manufactured exports corresponds especially to "new" industries, including both labour-intensive and capital-intensive products (see table 6). This category of "new" industries includes a wide number of products, as

27 ECLAC, 1995a.

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Table 5 Intraregional and Total Exports, 1990-94
(billion of dollars and percentage shares)

	1990	1991	1992	1993	1994[a]
LAIA					
– Intraregional	12.2	15.0	19.4	23.2	27.0
– World	112.7	110.6	115.7	122.2	138.0
LAIA/World	10.8%	13.6%	16.8%	19.0%	19.6%
Andean Group					
– Intraregional	1.3	1.8	2.2	2.9	3.4
– World	30.8	28.6	28.1	29.7	33.5
Andean Group/World	4.1%	6.2%	7.9%	9.6%	10.0%
MERCOSUR					
– Intraregional	4.1	5.1	7.2	10.2	11.4
– World	46.4	45.9	50.5	54.3	59.7
MERCOSUR/World	8.9%	11.1%	14.3%	18.8%	19.1%
CACM					
– Intraregional	0.6	0.7	0.9	1.2	1.2
– World	3.9	4.0	4.7	5.1	5.7
CACM/World	16.0%	17.4%	19.8%	22.6%	21.6%
CARICOM					
– Intraregional	0.4	0.4	0.5	0.6	n.a.*
– World	3.9	4.0	4.7	5.1	n.a.*
CARICOM/World	12.6%	11.6%	11.6%	12.8%	n.a.*
Latin America and the Caribbean[b]					
– Intraregional	16.0	19.3	24.4	29.2	33.5
– World	122.0	120.3	127.6	133.7	150.0
LAC/World	13.1%	16.0%	19.2%	21.8%	22.3%

Notes: *a* Figures exclude gross and net exports of maquila.
b Includes LAIA, CACM, Bahamas, Barbados, Belize, Dominican Republic, Guyana, Haiti, Jamaica, Panama, Suriname and Trinidad and Tobago.
* Not available.
Source: ECLAC (1995a), on the basis of official data.

varied as machinery and equipment, cars and other vehicles, household appliances, and chemicals.

The diversification of products and markets has assumed different forms within the region.[28] Brazil, and to a lesser extent Uruguay and Colombia, have achieved the highest degree of diversification. They have substantially reduced the share of their 10 principal products in total exports. They have increased the number and importance of non-traditional primary products

28 See ECLAC, 1995b, ch. III.

Table 6 Latin America (14 countries)[a]: Composition of Exports by Destination, 1970-1974 and 1992 (percentages)

	United States		Japan		Latin America and the Caribbean		EEC and EFTA		Total	
	1970-1974	1992	1970-1974	1992	1970-1974	1992	1970-1974	1992	1970-1974	1992
A. Primary commodities	47.0	39.8	66.1	48.3	51.0	25.1	59.6	43.8	53.6	36.3
1. Agricultural products	25.5	15.1	32.8	17.4	11.7	9.4	46.9	26.6	29.9	16.6
2. Mining products	6.3	0.9	31.5	20.0	1.0	2.0	6.7	6.9	6.2	4.4
3. Energy products	15.2	23.8	1.8	10.9	38.3	13.8	6.0	10.3	17.6	15.3
B. Industrialised products	52.6	58.9	32.0	50.4	48.8	74.4	40.0	54.1	46.0	62.1
1. Semi-manufactures	40.1	22.1	27.1	38.0	23.3	25.1	33.6	34.2	33.6	28.5
1.1 Based on agriculture and labour-intensive	5.6	5.1	3.1	7.8	7.5	7.8	15.8	17.0	9.5	10.2
1.2 Based on agriculture and capital-intensive	8.6	1.8	6.1	6.6	3.1	3.6	2.6	4.6	6.0	3.9
1.3 Based on minerals	6.7	6.2	17.2	23.6	6.4	8.2	13.5	11.1	9.2	9.1
1.4 Based on energy	19.2	9.1	0.7	0.2	6.2	5.5	1.7	1.4	8.9	5.3
2. Manufactured goods	12.5	36.8	4.9	12.4	25.5	49.4	6.4	19.9	12.4	33.6
2.1 Traditional industries	5.0	8.6	2.0	1.4	4.8	8.4	3.6	6.3	4.3	7.3
2.2 Basic-input industries	1.6	4.5	1.1	5.8	4.8	10.7	0.7	3.7	1.9	7.3
2.3 New labour-intensive	3.9	11.0	1.5	4.1	8.7	13.0	1.0	5.8	3.6	9.1
a) Low technological content	0.4	1.3	0.1	2.3	1.7	2.1	0.2	0.6	0.6	1.3
b) Medium technological content	1.6	5.7	0.2	0.4	4.1	6.7	0.4	1.3	1.4	3.0
c) High technological content	1.8	4.0	1.2	1.4	3.0	4.2	0.4	1.3	1.4	3.0
2.4 New capital-intensive	2.0	12.6	0.4	1.1	7.2	17.3	1.1	4.1	4.6	9.8
a) Low technological content	0.3	0.5	0.0	0.4	0.7	1.1	0.0	0.1	0.3	0.5
b) Medium technological content	1.3	10.4	0.3	0.5	5.0	14.4	0.6	2.9	1.7	8.1
c) High technological content	0.4	1.6	0.1	0.1	1.5	1.8	0.4	1.0	0.6	1.3
Other	0.4	1.3	1.9	1.3	0.2	0.5	0.4	2.0	0.4	1.6
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Note: *a* Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Guatemala, Honduras, Mexico, Paraguay, Peru, Uruguay, and Venezuela.
Source: ECLAC (1995b) table III.9., on the basis of official data. The criteria for classification of exports is detailed in "Estudios e Informes de la Cepal", No. 88, November 1992, pp. 30-34.

and semi-manufactures, as well as successively incorporating various types of manufactures in their exports. Mexico concentrated on sales to one destination (the United States), but diversified the composition of its exports, especially in manufactures, by incorporating new products. Argentina's diversification has been somewhat erratic as a result of political changes and the successive recessions of the 1980s. Nevertheless, though less intensively than Brazil and Mexico, it has diversified its supply of commodities and semi-manufactures as well as some manufactures, and the destination of exports.
Chile boosted its exports of manufactures to the region, although from a reduced base, and diversified exports of natural resources and semi-manufactures. Peru, without modifying the essential features of its specialisation, incorporated a number of manufactures. Exports from Ecuador, Bolivia and Paraguay were concentrated on a few primary products and were channelled towards one main market: the United States for Ecuador, Latin America for the other two countries.

Latin America and the Caribbean are very important and dynamic markets for the sales of manufactures for several LACs.[29] For Chile, Colombia and Ecuador this is by far the largest market, whether for traditional manufactures, basic inputs or new industries. This concentration is not so marked in the case of Argentina, Paraguay and Uruguay. They have a considerable diversification of markets for their traditional industries and, in Argentina, also for exports of basic inputs. However, Latin America has been and continues to be the almost exclusive destination for exports from the new industries of these countries. The same is true of the subregional market as regards the new industries of Costa Rica and Guatemala. Brazil has channelled its export manufactures to different markets. The United States continues to be the main buyer of traditional products from Brazil, followed by Europe. As for basic inputs, other developing regions have displaced Latin America as the main destination, but in the case of new industries, the region is the most important market for Brazil. A significant exception is the case of Mexico, where the regional market for new exports has less relative importance than the United States.[30]

Intra-Regional Trade and Technological Intensity

Development based on a growing and sustained international competitiveness is boosted by the dynamic effects derived from technological

29 ECLAC, 1994a.

30 Regressions carried out by ECLAC for the period 1970-91 show that there was a strong positive relationship between the importance of Latin America as a destination and the share of new industrial products in total exports of Argentina, a relationship that is positive but less intense for Brazil. In Chile, the exercise revealed a strong positive correlation for all

apprenticeship. The strategies to improve international linkages, based on productive development, emphasise the role played by trade in the process of stimulating the development of activities which make intensive use of knowledge and technology, and generate externalities in these areas.

It is a common belief, well supported by standard trade theory, that exchange among developing countries tends to concentrate in goods that are more technology-intensive than exports from developing to industrial countries.[31]

Studies based exclusively on foreign trade data confirm this argument. Table 6 shows how intra-regional exports are more intensive in technology, particularly advancing from low to medium technological content, more suited to the semi-industrialised stage of Latin America.

The same conclusion is also corroborated in a more recent ECLAC study[32]which combines data on trade and on domestic output. The figures show that products which encounter a relatively high share of their demand in the regional market exhibit more advanced technological characteristics than exports channelled toward extraregional markets.[33] Thus they can contribute with larger externalities to the domestic economy, and thence to productivity increases.

From the research carried out by ECLAC,[34] three main conclusions emerge:

- Regional trade has more sophisticated technological features. Such goods are to be found mainly in the chemical sector, non-electrical machinery and transport equipment. They are also sectors in which international demand tends to be more dynamic. Their price trends are more stable and tend to evolve more positively over the long term than prices of traditional exports intensive in natural resources.
- The sectors which exhibit a strong export drive toward the region also tend to show – frequently with a lag – a drive towards extraregional markets, which suggests that the promotion of intra-regional trade has a significant space for complementarity with the promotion of extraregional exports.
- These same sectors are those in which the region has a high dependence on extraregional intermediate imports, and therefore intra-regional trade benefits from having access to inputs and equipment which may be imported from third countries. Consequently, the relaxation of excessive import restrictions has contributed to foster and upgrade exports.

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31 Different policy approaches tend to share this prediction. However, they diverge on the policy implications that are derived from it.

32 Buitelaar, 1993

33 ECLAC, 1994a.

34 See Buitelaar, 1993

To sum up, intra-regional trade, because of its different characteristics – associated with vicinity, the diverse marketing channels and features of markets of destination –, complements the LACs' linkages with the global economy. Actually, it provides a dynamic context of technological apprenticeship and use of economies of specialisation, leading to greater and more efficient international competitiveness, with an increasingly more diversified basket of products and balanced pattern of specialisation.

Economic Recovery and Intra-Regional Exports

Recovery of economic activity in LACs has undoubtedly been associated with the renewed access to external financing.[35] However, booming intra-regional trade has contributed to the real counterpart of the adjustment process that is under way. Particularly, the encouragement of intra-regional exports, in the framework of adjustment with recession that was still prevailing in the late 1980s, has increased the demand for domestic resources and for investment. In fact, it made the rise in aggregate demand more intensive in effective demand, as compared to a scenario without any integration effect.

The particular conjuncture faced implied that there was installed capacity to respond to the increased demand for non-tradeables and for new tradeables for regional markets. Since this demand has been sustained for several years, it has also encouraged investment pari passu with the shortening of the gap between capacity and use of it.

Tariff preferences, removal of import restrictions and creation of additional outlets for domestic output (harmonisation of standards, transportation, improved infrastructure, marketing channels, reciprocal investment, etc.) explain the existence of a bias in the composition of expenditure and output. However, exchange-rate movements have reinforced a restructuring of output in the direction of increased reciprocal trade as compared to exports to the rest of the world. In general, real exchange rates appreciated for producers of tradeables offered to third countries, while they have remained more stable among LACs.[36]

Table 7 presents a very rough estimate of the high weight achieved by reciprocal exports in the increase experienced by the effective demand for domestic resources (obviously, by definition, equal to the increase in GDP)

35 ECLAC, 1995b, ch. XI.

36 Recall that appreciation has worked principally vis-à-vis non-regional currencies. Between 1990 and 1994, the large majority of LACs had revalued their exchange rates with respect to the rest of the world.

between 1990 and 1994; all figures are measured in 1980 US dollars.[37] GDP rose US$116 billion and exports of goods and services increased by US$50 billion, that is 43% of the additional GDP available. It is evident that exports are a leading component of growth. Of that percentage, an estimated 54% was generated by intra-regional exports.[38] Thus reciprocal exports have been more significant than exports to other regions. If we take into consideration the different quality of reciprocal trade, the significance of LACs in the recovery of the region is further enhanced.

Table 7 Growth of GDP, Intraregional and Extraregional Exports in Latin America, 1990-94
(billions of 1980 dollars)

	1990	1994	Growth rate	Growth amount	Share in GDP growth
GDP	829.2	945.2	14.0%	116.0	
Exports	172.7	222.7	29.0%	50.0	43.1%
Intraregional[a]	22.6	49.7	120.0%	27.0	23.3%
Extraregional[a]	150.1	173.0	15.3%	23.0	19.8%

Notes:
a Total exports of goods and services disaggregated according to the shares in current prices of exports of goods in 1990 and in 1994. Services are principally freight of merchandise, transportation of people, and tourism.
Source: ECLAC, for 19 LACs, on the basis of official data, converted to 1980 US dollars.

Of course, if one works with per capita figures or with current dollars, the relative weight of regional trade becomes notably larger. Evidently, intra-regional trade made a significant contribution to the recovery of the real economies of LACs.

37 The very rough estimate has several biases. However, since the results are extremely strong, those biases do not invalidate the conclusions of the text. The main biases relate to: (a) export figures are, as usual, gross of imported inputs; consequently, they overestimate the weight of exports in effective demand; (b) the composition of trade is in current dollars, data that are crossed with the share of trade in GDP in constant 1980 dollars; probably, the prices of exports to LACs performed better than those to the rest of the world, which deteriorated sharply in 1980-94.

38 The equivalent figure for 1990-93 was much higher: two-thirds. The change with respect to 1994 reflects the softening of the rise in trade among LACs. Anyway, the latter continued to increase faster than exports to the rest of the world.

IV Some Omitted or Pending Issues

Regional economic integration offers significant economic as well as political, social and cultural benefits to Latin America. However, we are certain that transition can involve large costs and uncertainties.

The first years of the present decade have implied a relatively easy transition. Integration took place amid a recovery of economic activity and with intra-regional imports which had been overadjusted downward. Thus, space for large non-conflictive increase in reciprocal trade was at hand. As shown, the region made good use of this opportunity.

Macroeconomic equilibrium was also, apparently, being achieved in a sustainable way. Unfortunately, progress in stabilisation of price levels and fiscal balances was being achieved, at least partially, at the expense of investment in people and in infrastructure. In parallel, a too rapidly growing deficit on the current account was being generated. In fact, the deficit of the region multiplied by five between 1990 and 1994, rising to US$50 billion. Financial markets appeared willing to overfinance those growing deficits until November 1994. In fact, in 1992-94 the region received a yearly net inflow averaging US$60 billion, a figure clearly in excess of the absorptive capacity of the LACs' economies. As a consequence, Latin America accumulated huge international reserves, equivalent to 6.5 % of GDP in 1991-93.

As is well known, the mood of the market changed abruptly at the end of 1994. This implies that some LACs will have to start, once again, deep downward adjustments.

These are two general issues that pose a challenge to future progress in regional cooperation. As the easy stage of rising reciprocal trade approaches an end, effective mechanisms of solution to disputes and harmonisation of macroeconomic policies will come more in demand.

The convergence of the more than two dozen partial agreements will also require imaginative tackling and soon rather than late. The sooner the convergence is agreed and implemented, the lesser will be the consolidation of contradictory and divergent trends, thus minimising the need for subsequent costly productive restructuring. The convergence could proceed more expeditiously if one scheme, for instance Mercosur, itself becomes a focus of attraction for other LACs or groups of them.

NAFTA might also be a complicating issue, posing additional challenges to the needed convergence within Latin America. This last issue is covered in the paper by Roberto Bouzas in this volume.

Finally, the distribution of benefits and costs among partners has been absent in the policy and academic efforts of the 1990s. The issue is obviously less visible in the particular macroeconomic and reciprocal trade conjuncture faced in the early 1990s. In the future it may become more significant for

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achieving sustainability of regional cooperation and a better reaping of potential benefits. The issue would also become more relevant when any country or group of them merges with another group, affecting the profile of trade creation and diversion.

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Comment on "Trends in Regional Cooperation," by Ricardo Ffrench-Davis

Robert Devlin

Ricardo's contribution is an overview paper; it covers many points and indeed raises most of the issues I would have raised myself if I had been writing the paper. I usually agree with Ricardo and once again that is the case. So really my comments will be basically reinforcing some points and emphasising some areas more than he did.

I have divided my comments into two parts, one on historical developments, an area extensively covered in the paper, and the other on the contemporary situation. The history refers to the 1960s and the 1970s, and includes the 1980s as well.

History

In the case of obstacles, Ricardo mentions a number of them regarding what happened to the historical process of integration before this transformation that was experienced in the 1980s. I would stress a couple of points here.

One point is that the integration process during the 1960s and 1970s confronted a hard reality: that there was little commercial tradition in Latin America. I was always struck by the fact that Argentina did more trade with Holland than it did with Brazil. So I think this was one major obstacle that should be brought out.

Another problem was that the motivation for integration wasn't really international competitiveness and the promotion of exports per se; it was rather an extension of the existing import-substitution policy which was based on physical expansion of the national industrial plant rather than to compete internationally. This had two consequences. One was that this integration effort was not able to resolve the problems of the import-substitution strategy because it ran up against the same barriers: high levels of national protection and the inherent inefficiencies associated with that. So the solution was overcome by the problem itself. And two, Ricardo points out that one of the results of this integration process _ which of course was not entirely negative by any means – was that there was an increase in intra-regional manufactured exports. But I think precisely because of the strategy – the extension of the

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national market via import-substitution – that it is questionable whether these manufactured exports were, strictly speaking, internationally tradeable goods. This is reflected in the automobile industry where there was tremendous physical development, but where it is doubtful that many of the models could be sold or traded internationally. Brazil itself was, to some extent, a victim of this approach (partly because of the strategies of the multinationals). When Brazil finally started to try to export its cars to Europe and the United States it ran into big problems with quality, not to mention the obsolescence of the models themselves.

There are other obstacles that were very important. One was that the integration process was rather shallow and so, after trade was liberated among partners, one still had to confront a lot of non-tariff barriers. Moreover, there were no extensive agreements in some of the areas that support trade and services and that reduce risks on private investment. The old LAFTA framework also suffered from a degree of inflexibility; it was bound by MFN considerations that were resolved only later in the Treaty of Montevideo II, when countries could sign "partial agreements" and not necessarily extend the benefits to everybody within the region.

Finally, there was historically the question of the symmetry of benefits between the more developed and less developed countries in the region. There was much tension in that period because the smaller countries essentially had deficits with the larger countries and they had to finance these deficits by selling their primary commodities overseas. There is actually an excellent article by Germanico Salgado in the Revista de la CEPAL[1] where he examines this tension; if that is an accurate reflection of what was going on during the period, asymmetric benefits were a major issue.

Contemporary Situation

In the contemporary experience up into the 1990s, one would draw out more the effect of unilateral liberalisation on intra-regional export growth. What happened here is that with the reduction of tariffs around the countries, there was a spontaneous development of natural trading areas and this explains to an important degree the growth of intra-regional exports. This of course has been reinforced by formal agreements such as Mercosur and Colombia-Venezuela, but the unilateral reduction of tariffs has something to do with the booming of intra-regional exports during the early 1990s.

1 Germanico Salgado, "El Mercado Regional Latinoamericano: el Proyecto y la Realidad", *Revista de la CEPAL*, No 7, April 1979.

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Likewise, because there was a lowering of tariffs in the late 1980s and early 1990s, one would think that the intra-regional trade that is going on now – which is also heavily oriented towards manufactured goods – is effectively producing goods that are internationally tradeable and in this sense it does probably serve better than in the past as a platform for international competitiveness. This is a point that could be brought out to contrast with the earlier period.

Ricardo makes an interesting point, one of the many interesting points in the paper, when he stresses that during the 1980s intra-regional exports suffered in part because of the simultaneous devaluations in the region. There was a collapse of foreign capital flows and with that real devaluations; the simultaneous change in relative prices gave an impulse to extra-regional exports as opposed to intra-regional exports. Well, one could use the same logic for the boom in the 1990s. Because what happens is that there is a sharp increase in capital flows, appreciation of exchange rates and therefore, using the same logic, a bias towards intra-regional exports. I think that this is important because it suggests that a little caution may be merited about the success of intra-regional exports; it moreover leads to a question: are our intra-regional export substituting for a lack of international competitiveness? Yes, I think that may be happening to some extent. It is very evident in the Andean Group where there is practically no growth of extra-regional exports, while intra-regional exports are growing very strongly.

Now, the paper also stresses five points concerning why countries are considering intra-regional accords and they are all oriented around market failure. They are five very important points I fully agree with. I think they are all reasons to consider intra-regional accords and in fact reinforce the whole point of integration: to overcome some obstacles of a "Second Best World". However, I am not sure that they are the main driving forces. Indeed, I think there is also a strong political motivation behind what is happening.

One is that countries were trying to "lock in" their policy reforms and also were trying to provide signals of commitment to the international financial markets, especially in the case of North-South type integration agreements. This political economy component is clearly driving integration. And second, there is a defensive reaction which I think is very important. Governments are signing agreements just because they see their neighbours signing; they don't want to be left out in the cold without a preferential partner.

This leads me to another point. Today it is really hard to discuss regional integration without talking about hemispheric integration and the global economy, which is also consistent with the whole issue of open regionalism. I say this because if you just focus on Latin American integration, or Latin American-Caribbean integration, you miss a lot of points. There is the question of defensive reactions. It is a real issue – when a country joins a new

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accord, what are the effects that it has on existing accords? The most notable case would be the effects of NAFTA accession on the Central American Common Market and the Caribbean Common Market, etc. It could lead to trade and investment diversion and a weakening of sub-regional accords, even though many people feel existing sub-regional accords are "building blocks" for hemispheric integration. There is also the question of compatibility of accords; the question of the development of poles – the Mercosur-NAFTA dynamic is an interesting one – and, of course, the North-South adjustment issues. These considerations can't be very well developed in a paper that focuses exclusively on regional issues, although this problem is more due to the structure of the conference than anything else.

The other point is what I mentioned yesterday: that one must look at regional integration in the light of multilateral trends and the WTO, above all the Article 24, which in principle now, due to the new Understanding that came out of the Uruguay Round, could in fact become an effective instrument for surveillance and evaluation of intra-regional accords.

To end, just some other contemporary issues could be developed. The question of institutional barriers: integration is taking place with, in many cases, an institutional structure that was set up in the old framework of import substitution; there are many commercial mechanisms and instruments which really are not uptodate for an internationally competitive type of open regionalism. So this is an area where there is probably need for reform and modernisation of institutions, for instance in dispute settlement.

There is also the issue of asymmetric benefits. While not fashionable today, I think it is still a problem that must be addressed.

There is the question of macroeconomic frameworks in the context of convergence: this is an issue where there are more questions than answers; somebody like Ricardo, who has a very strong macro-background, could fill this out very well.

There is the private sector dynamic which was mentioned yesterday: the private sector is a very important actor; indeed there is much spontaneous development of integration trends in the region.

And of course, the last thing is information. I am working on the question of hemispheric convergence and we are trying to gather data on the different accords and their norms and regulations. It is not easy. A private sector actor who wants to identify the rules of origins for products X, Y, Z at eight digitsmight have a difficult time. In effect, the system isn't set up to provide easily accessible information for the private sector, which in the end is the leading protagonist in this whole recent explosion of intra-regional trade.

Floor Discussion of the Ffrench-Davis Paper

The paper by Ricardo-Ffrench-Davis and subsequent comment by Robert Devlin engendered a very rich discussion about the relations between finance and trade and how one could explain the rise of intra-regional trade in Latin America. But first Renato Baumann, economic affairs officer at ECLAC-Brazil, added some information on Mercosur.

The Case of Mercosur

Baumann highlighted the remarkable increase in trade within the Mercosur region. Exports of the four members (Brazil, Argentina, Paraguay, Uruguay) to the regional market increased from 4 billion dollars in 1990 to 11 billion dollars in 1994, augmenting the share of Mercosur in total exports of the four countries from 9 per cent in 1990 to 19 per cent in 1994. Imports rose from 4 billion dollars in 1990 to 9.6 billion dollars in 1993, increasing the share of Mercosur in total imports from 14.5 per cent in 1990 to 20 per cent in 1993. According to Baumann it is, however, difficult to assess how far these increases in intra-regional trade can be attributed to the existence of the Mercosur integration agreement. At least four specific explanations could be given, he said.

"First, there is the effect of some specific protocols, of which the protocol on wheat is the best example. This made Brazil import wheat from Argentina, even when the Canadians and the Americans had been trying to supply the same product more cheaply. Second, there is the effect of exchange rate differentials – exchange rates moving sharply – between the member countries of Mercosur. The overvaluation of the Argentinean peso, for instance, explains to a large extent why Brazilian exports to Argentina increased substantially in 1992-1993. Third, there is the effect of intra-industry trade. Intra-industry trade between Brazil and Argentina accounted for 23 per cent of total bilateral trade in 1986 and rose to 38 per cent in 1990, and a similar increase in intra-industry trade has occurred between Uruguay and Brazil. Fourth, there is a conjunctural factor. This has to do with the point stressed by Robert Devlin, that in the analysis of the regional experience one should take into account what is going on at the global level. A good deal of Brazilian exports of automobiles to Argentina, for instance, had to do with one specific car manufacturer which traditionally had a sort of market reservation in its home country – which is not Brazil but the home country of the transnational

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company. The company lost it due to multilateral negotiations and had to divert the sales of certain products that were produced in Brazil to Argentina."

Given these specific explanations Baumann warned against drawing general conclusions from aggregate trade figures. "You have to get into details to know exactly what is going on. Probably one of the conclusions from a closer look at the Mercosur experience is that it is too recent a phenomenon to allow definite, affirmative statements with regard to exchange rate movements and so on. It certainly calls for a differentiated analysis of the specific role of the exchange rate."

Baumann observed that, in a similar way, more detailed analysis would be needed if one tried to explain the increase in intra-regional direct investments. "As Stephany Griffith-Jones' paper shows, foreign direct investment among Latin American partners is increasing and this is true for Mercosur as well. The anecdotal information in the press is that today there are 400 Brazilian enterprises in Argentina with investments coming close to 700 million dollars. It seems that Brazilian companies are investing in Argentina because of differences in tax structure, which is an aspect we have not dealt with in our discussion. Probably there is a new phenomenon here which has to do not exactly with tax evasion but with the treatment of income taxes, tax on production factors, and so on. Anyway, this example also points to the need for a more specific analysis," Baumann said.

Regarding Mercosur's relations with other regions Baumann noted that other Latin American countries may join Mercosur in the near future. "Brazil has a geographic frontier with ten other Latin American countries, which prompted the country in October 1993 to propose the creation of a South American Free Trade Area (SAFTA) and this was formally adopted as a Mercosur proposal in May 1994. Apart from that, Chile, Bolivia and Venezuela, among others, have manifested interest in joining Mercosur and having some sort of specific, differentiated participation in it. In parallel, negotiations have been held with other LAIA members to establish by the end of June 1995 the basis of a free trade area to be formed in 10 years. Preliminary contacts have been made also with the Australian-New Zealand Free Trade Area. The European Union approved in December 1994 a resolution to start negotiations with Mercosur for an inter-regional agreement. And last but not least, in the Miami Summit of 1994 it was agreed that by June 1995 there should be negotiations with NAFTA about the establishment of a Hemispheric Free Trade Area by the year 2005."

One important addendum to Baumann's presentation was made by Argentinean economist Roberto Bouzas. "In the case of the wheat protocol mentioned by Baumann the real issue is that in Mercosur a common policy is being developed of how to treat extra-regional subsidies. The issue goes

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beyond the protocol and really is to develop a common way of dealing with subsidised imports, unfair imports, into the customs union. That is what is really at stake."

Exchange Rates, Intra-Regional Trade and the Rationale of Integration

Ricardo Ffrench-Davis' assertion that the depreciation of Latin American currencies in the 1980s had discouraged intra-regional trade aroused a variety of comments. Jaime Ros, a Mexican economist working at the University of Notre Dame in the United States, started off the debate by disputing the logic of Ffrench-Davis' argument.

"I don't follow the logic in Ricardo's presentation about the collective Latin American devaluation of the 1980s having a negative effect on intra-regional trade. Even though this collective devaluation did increase extra-regional exports it also decreased extra-regional imports. The effect on intra-regional trade vs. extra-regional trade seems to me ambiguous. The key issue is whether the collective devaluation was contractionary or expansionary vis-à-vis the region's level of economic activity. It may well be that the devaluation was initially contractionary vis-à-vis the level of intra-regional trade – similar to the contraction of economic activity brought about by the adjustment process. But it may well be also that, after these contractionary effects operated, we have entered a period of expansionary effects on intra-regional trade – some of which we may be still witnessing today. That is, some of the increases in intra-regional trade – intra-regional exports and imports – may well be still the last effects of the undervalued currencies that we had throughout the 1980s and early 1990s," Ros said.

Hector Assael, chief of the International Trade, Finance and Transport Division at ECLAC, followed up on the issue, arguing that one should also take into consideration whether the countries concerned were in the dollar zone or the non-dollar zone. "The devaluation of the 1980s occurred at the time of the strong dollar and the appreciation of the 1990s occurred at the time of the weak dollar. So it is important to know whether we are speaking in terms of devaluations or appreciations against the dollar or against a basket of currencies."

Assael further believed that one should distinguish between both the amount of loans received and the type of loans. "Because when you have a difficult period, you are receiving small amounts of loans and a lot of these loans – suppliers' credit and so on – are tied to buy imports in the developed countries. But when you receive a lot of loans, like in the 1990s, they are mostly private loans which are open to buy in any place you want. If in the future we will receive less loans and more of these loans will be tied to

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importing from developed countries, you may see again a decrease in intra-regional imports."

A third observation by Assael was that intra-regional trade does not depend only on macroeconomic issues. "In the early 1990s we had a study made by a German economist and the explanation he gave for the rise of intra-regional trade between Argentina and Brazil was that it was affected not by differences in the exchange rate but mainly by the economic situation in both countries. We have to take into consideration not only macroeconomic explanations but also other kinds of explanations."

Shahen Abrahamian, officer-in-charge of the Global Interdependence Division at UNCTAD, supported Assael's view. "The macroeconomic factor has been very important, but the challenge is to break that macroeconomic link and not let intra-regional trade become the hostage of macroeconomic causes. I mean, one should try to detach it from the effects of financial sector movements as opposed to real sector adjustments. Robert Devlin was going in this direction: make Latin American trade more dependent on real competitiveness and mutual competitiveness, not relative exchange rates. I think Ricardo is right that in the future you are going to have a harder time generating intra-regional trade and you should do it with the governmental agreements to foster trade. It cannot be done through relative exchange rate movements. It cannot be done entirely through unilateral liberalisation. It cannot be done through the global system. Regional cooperation can do it, but it's going to be tough."

Abrahamian also dwelled on the logic of Ffrench-Davis' statement – contested by Jaime Ros – about the link between exchange rates and intra-regional trade. "There may be a link between exchange rates and the net inflow of resources. You may have decade-long movements of financial glut followed by financial shortage, each of them associated with an exchange rate movement. The point is that when there is a lot of money coming in, your currency appreciates. But when everybody's exchange rate in the region is appreciating, no one is becoming less or more competitive with the others. What does promote your exports is the aggregate growth of imports of your neighbours in Latin America. Conversely, when the money is going out, or not coming in, there is a devaluation which doesn't affect your relative competitiveness but does affect the demand pull from your neighbours. So if you were to have a world without capital movements, just exchange rates and trade balances, Jaime Ros would be right: you could get a devaluation and, at the same time, an aggregate increase in imports which would not necessarily reduce intra-regional trade. But in practice that is not what happens."

Claudia Schatan, economic affairs officer at ECLAC-Mexico, noted that the recent devaluation of the Mexican peso demonstrated that diverging exchange rate movements within a region do matter. "Perhaps in the future

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exchange rates will converge again, but as it is now – with an extremely devalued currency in Mexico – we have very different kinds of exchange rate movements, in part of the region at least, and overlapping trade agreements. We can start seeing the effects of the rush there has been recently for signing these trade agreements between Mexico and the US and between Mexico and the smaller countries of Central America. The US is suffering some effects of the tremendous contraction of the Mexican economy, but the Central American countries are really scared by the situation. Because there is a free trade agreement between Mexico and Costa Rica, the Costa Ricans are frightened that they will be invaded by cheap Mexican products. More generally, the Central Americans are worried that some of the products that cannot be exported from Mexico to the US – not because of prices but because they are not competitive in terms of quality – will be dumped in the Central American region through Costa Rica. Costa Rica has this free trade agreement with Mexico and from there there's nothing that will stop Mexican products from going to the rest of Central America because there is the free Common Central American Market. The possibility of getting a very unfair trade practice through this new exchange rate is very worrisome."

Cristian Ossa, a Chilean economist and director of the Department of Economics and Social Information and Policy Analysis at the UN in New York, returned to basic underlying assumptions and questioned the rationale of integration put forward by Ffrench-Davis.

"The strategic decision of countries is to integrate into the world economy and regional integration should be part of that process. But what I see in Ricardo's approach to regional integration is that it is meant to reduce the costs of integration into the world economy rather than to assist in the process of integrating into the world economy. In a sense, Ricardo's approach is back to the 1960s rather than looking at the 1990s and into the next century. It is too much of a defensive approach. Compensating unilateral import liberalisation with regional integration might be a second best, but why not opt for an approach à la Korea, Taiwan, Malaysia, Thailand, Indonesia, or, if you wish, Chile, where the emphasis is not on regional integration but on opening up? The Asian NICs have growth rates of 6, 7, 8 per cent. Latin America in the 1980s had barely 1 per cent, and now it has 3 per cent and we seem to be satisfied."

Finally, Percy Mistry, an Indian economist engaged in finance and policy research, said he had the impression that – even in the 1990s which began so optimistically – Latin America seemed to remain extraordinarily prone and vulnerable to macro-financial shocks, whether caused by inflows or outflows.

"There is a feeling that both seem to be bad, and that there is somewhere a right amount in between which one must try to find, while I think that the real question may very well be: Why is it that a region which is so incredibly

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rich in capacity still finds it elusive to achieve the kind of durable real sector adjustments where things like exchange rates, deficits etc. are driven by real sector movements and not continually derailed by financial sector movements? It is a rather fundamental issue; it is just as simple as the fact that these problems would be solved if the domestic savings rate would go up to 30% and remain there thereafter. Why is Latin America, after 30 years, still so prone to macro-financial shocks? What the implications of that are for durable vs. non-durable integration, or whether people see integration as a soft option to moderating the financial shock effect as opposed to looking at domestic responses which anchor these economies much more solidly, one does not know. But it is certainly an issue that ought to be looked at."

Reply by Ricardo Ffrench-Davis

First, on the issue of exchange rates and intra-regional trade, what I tried to emphasise was that the exchange rate – the devaluation of Latin American currencies in the 1980s – has been an important factor. If we look at exports we see that a country that devalued in the 1980s was changing not only one price relation, but two price relations, because there are tradeables – and that has to do with the first comment by Robert Devlin – with the world, tradeables with the region and non-tradeables. Some tradeables with the world are also tradeables with the region but some are not. In some cases the one has helped the other, in other cases the one has substituted for the other or they have been completely separate. But in broad terms we have seen the phenomenon that if two Latin American countries devalue, they improve competitiveness with the rest of the world, but they don't improve competitiveness with one another. Looking at it from the export point of view, this means that the composition of non-tradeables vs. reciprocal, regional tradeables is affected. Then, in the 1990s, we experienced the opposite: we improved competitiveness within the region and, because of an appreciating currency, we became less competitive with the rest of the world. So today it is more difficult for Latin America to sell in Europe and the US than to sell within Latin America.

Hector Assael raised the point of different exchange rate markets. However, I always try to talk in terms of real exchange rates which are determined by a basket of currencies. In the case of Mexico the basket is mostly the US dollar; in the case of Brazil, Argentina or Chile, the US dollar is only one component and the Deutsche Mark and the Yen are also important – as well as the exchange rates of Argentina, Brazil and so on – in affecting average relative prices. This explains some differences among countries, but the big trend has been that Latin America appreciated in the 1970s, depreciated in the 1980s, appreciated in the 1990s, and in all cases very

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strongly. Today the appreciation may not be as strong as in the 1970s for the total region, but for several countries the appreciation is as large as the one suffered in the 1970s.

Hector Assael and Shahen Abrahamian questioned the role of macroeconomic factors. I fully agree with them and wished that from now on macro would be less relevant. In the 1980s, however, it was a very strong factor explaining many things that happened, and in the early 1990s it remained a strong factor explaining what happened. The recovery of GDP of Latin America was macro, it was not the creation of capacity, the expansion of the productive frontier – that was moderate, close to the growth of population. A significant component of moving from below up to the production frontier was the macro situation, led by capital flows. Argentina was 40 per cent below the production frontier and moved to the frontier, Brazil will be approaching the production frontier fairly soon, and Chile approached the production frontier already five years ago and stayed there. Obviously, the increase of GDP was led by real growth, by the creation of new capacity, by increased investment and productivity. It is also clear that the creation of productive capacity is more important than macro events in the financial sphere. In that sense Hector is very much right. But, in the end, it all depends on how one creates capacity, how the increase of productivity is distributed and how the market signals are directed towards domestic markets, intra-regional markets and extra-regional markets. It may well be that in the future we will be somewhat less dependent on the overall macro situation than we have been in the 1980s and early 1990s. I hope so.

To take the point raised by Claudia Schatan, indeed, Mexico has had a very significant effect in the neighbourhood, because of vicinity and because of the integration agreements – not only on trade but also on investment. There is going to be a diversion of investment toward Mexico. For investors with a long-term horizon Mexico is going to be profitable in the next 15 years. There may be problems for 1, 2, 3 or many years, but with the present low exchange rate it is very profitable to go into Mexico. In Central America the effects will be important, maybe also in Venezuela, Colombia and Chile.

Cristian Ossa has raised several questions which go much beyond my paper. They touch on what I was doing until a month ago, but I closed that and I will not repeat what I was doing before. So I omitted things on which I have been working before. I agree that it is crucial to take into consideration where one places the analysis. Import liberalisation is given, is there. We are not replacing it, we are living with it. So the real question is: What do we put together with it? One thing is real cooperation or preferences for reciprocal trade. This should be accompanied by more effective export promotion policies and more effective systemic policies, that is policies which improve systemic productivity. We have a very poor record on that in Latin America.

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Reforms have been weak and in some cases they have destroyed more than created during the transition. I recall that in Chile 8 or 10 years ago most people were saying that the economic situation was bad, because the costs had been very large in the process and costs always have to be counted. We must not omit them, we have to consider benefits and costs and try to make the transition better. And for that, we need, for instance, better export promotion policies. We have to improve policies in Latin America including exchange rate policies and many other things that will improve the investment climate for private economic agents. We should be doing that – with or without intra-regional cooperation – but we are doing very little. We did import liberalisation without many of the other things to complement the efficiency of import liberalisation.

Given this situation, intra-regional cooperation is not defensive, is not inconsistent with growth of exports to the rest of the world. It is inconsistent with the philosophy that exports to the rest of the world should be the only driving force. On average, if we use the right prices and the right policies, intra-regional preferences have a lot to offer, given that external tariffs in Latin America are relatively low, already much lower than the East Asian tariffs in the 1950s, 1960s, 1970s and early 1980s, and even lower than the Japanese tariffs until a few years ago, or the European or US tariffs in the 1930s, 1940s, 1950s and early 1960s. The costs of a too expensive trade diversion, I think, are rather limited and the space for improving efficiency through economies of scale, economies of specialisation and completing markets are significant.

Focusing on the case of Chile I think it is crucial to consider how long it took to reap the net benefits. It took a very long time. Only in 1992 average wages reached again the level of average wages in 1970. It was a very long process, because reforms were incomplete, naive, based too much on the belief that the market would solve everything. So they did not contribute to completing markets – in some cases they created markets, but they also destroyed several markets. Technology weakened, labour training weakened, people went into many years of unemployment or self-employment, and so on.

Now the situation in Chile might look good, but it took 22 years and that is very long. We can do things faster and we can improve a lot in the process of adjustment in Latin America by doing better export promotion, better labour training, improving education, and so on. Education is very weak in Latin America: there is more quantity, more years, but lower quality. Or take labour capacity: labour training is minimal compared to what happens in Korea, Taiwan, Japan or Malaysia. We are weak in all these things and that affects systemic productivity. So we need to improve systemic productivity and introduce some additional elements, one being intra-regional cooperation.

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I would like to add a small exercise that we did in table 7 of the paper; it deals with the relationship between the growth of GDP, on the one hand, and the growth of intra-regional and extra-regional exports, on the other. It starts in 1990, though, ideally, we should have started in 1980 in order to see what is recovery and what is creation. This table introduces the macro element that Robert said I had not put enough in my paper. If we look at what happened in effective demand – the demand for natural resources, labour and capital – there have been changes in real terms between 1990 and 1994. We can see in the table that exports have had a positive effect: they contributed to 40 per cent of the increase in GDP, and of this growth of exports about half was accounted for by intra-regional exports. So my conclusion is that, together with the other things – capital flows, economic reform, discipline, democracy, etc. – these intra-regional exports have contributed significantly to the recovery of Latin America, with the qualification that after 1994 the contribution is probably going to be smaller and more complicated.

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Preferential Trade Liberalisation in the Western Hemisphere: NAFTA and Beyond

Roberto Bouzas

Since the early 1990s "regionalism" has been on the rise. Out of ninety-eight preferential trade agreements notified under Article XXIV to the General Agreement on Tariffs and Trade (GATT), almost one-third were from the four-year period 1991 to 1994.[1] This revival of regionalism has raised the issue of whether the proliferation of discriminatory arrangements is compatible with a working multilateral trading system, or is contributing to its fragmentation instead.

Indeed both roads are open. Regionalism could certainly be a hindrance to multilateral arrangements. Yet this need not be the case. Since there are strong underlying factors pushing towards regional trade arrangements, the key issue is that of what mechanisms can be put forward to enhance the chances of regionalism not being detrimental to an effective multilateral trading system. Regionalism may even have a positive role to play in advancing economic integration among nations. For most of the postwar period the GATT has successfully promoted the removal of trade barriers applied at the border. Closer economic interactions have thus broadened the agenda of negotiations towards formerly unchartered areas. Some of these new areas had been traditionally in the "realm" of domestic policies. As the strains experienced in the concluding phase of the Uruguay Round demonstrate, harmonising these policies, practices and institutions is a slow and conflictive process in which multilateralism remains a key but hardly the only instrument.

Formally or informally, trade discrimination and regionalism have thus turned into the mechanism by which "like-minded countries" (or countries among which clear power relations prevail) foster "deeper integration" and policy and institutional harmonisation. If implemented in a way which is not detrimental to multilateral arrangements, regionalism could even pave the road towards enhanced economic interactions among countries, overcoming the obstacles posed by national diversity.[2] Yet in order for regionalism to be

1 World Trade Organisation, 1995.
2 Khaler, 1993.

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complementary and not detrimental to multilateralism, it must be "open". This means that it should not create incentives for increased economic interaction among partner countries at the expense of the rest of the world. Furthermore, regional initiatives have to be implemented paying due attention to its overall and systemic implications, particularly by large and influential players. The best guarantee would be an effective multilateral surveillance mechanism which makes sure that discrimination does not develop its feared potential to create resentment among nations, induce retaliation and further rumple the playing field of international trade negotiations. To be "open", regional initiatives should also have transparent rules for accession.

This paper reviews the challenges posed by the re-emergence of regionalism in the Western Hemisphere. It is true that, at least since the 1950s, the rhetoric of economic integration has not been strange to Latin America and the Caribbean (LAC). Yet the 1990s have brought new developments. On the one hand, for the first time in decades trade regimes throughout the region have become more open. On the other hand, in 1993 Canada, Mexico and the United States signed the first comprehensive free trade agreement between developed and developing partners (the North America Free Trade Agreement, NAFTA). Since one of its partners is the largest market in the hemisphere, NAFTA could hardly have gone unnoticed for the rest of the hemisphere. Eventually, in late 1994 negotiations to further a hemispheric free trade area were launched under the auspices of the United States. It is uncertain how this process will evolve. Yet the fact that it is simply on the table is in itself remarkable. Its policy implications can hardly be overemphasised.

Besides this introduction, this paper includes five sections. The first one reviews the background and environment to the "regionalist" revival in the Western Hemisphere. The second section briefly reviews the debate about NAFTA effects upon Mexico. The third section addresses the policy dilemmas posed by NAFTA to the rest of the LAC. The fourth section reviews the stylised responses of the LAC countries to the NAFTA challenge. Finally, a concluding section summarises some of the main ideas brought up in the paper and elaborates on alternative ways to foster hemispheric economic integration.

I The "Regionalist" Revival in the Western Hemisphere

Paralleling events in other regions of the world, since the early 1990s "regionalism" has revived throughout the Western Hemisphere. In effect,

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pre-existing preferential agreements such as the Central American Common Market (CACM), the Andean Group and the Caribbean Community (Caricom) acquired, at least temporarily, renewed life. Similarly, a brand-new set of bilateral and minilateral arrangements boomed, including the Canadian-US Free Trade Agreement (CUSFTA); the Southern Common Market (Mercosur) between Argentina, Brazil, Uruguay and Paraguay; and the North American Free Trade Agreement (NAFTA) between Canada, Mexico and the United States.[3] Furthermore, negotiations towards a hemispheric free trade area were launched after the Miami presidential summit of December 1994.

Yet to illustrate the intensity of regional initiatives, particularly in the Western Hemisphere, by the number of agreements signed may lead to mistaken conclusions. In effect, pre-existing arrangements experienced only a cosmetic revival and some of the new agreements are still on paper or display huge gaps between commitments and achievement.[4] The content of recent agreements is also disparate, although in general they have not increased protection vis-à-vis third parties and, at least in spirit, they cover a broader set of issues.[5]

For sure, the proliferation of discriminatory arrangements can be regarded as the repetition of an old theme, particularly in LAC. "Economic integration" was a key word in the LACs' international political economy in the 1960s, and since then it has never abandoned policy rhetoric if not substance. Yet the nature and incentives for trade discrimination have changed considerably throughout the Western Hemisphere in the 1990s. On the one hand, and for the first time in decades, economic considerations are dominant in the design of US discriminatory trade policies. On the other, the LAC countries have undergone a far-reaching process of unilateral trade liberalisation which has radically changed the environment in which regional initiatives have taken place. This has enhanced the prospects for preferential trade agreements among "natural" trade partners, which in the past remained isolated by high border barriers.

3 Other agreements include the Group of Three free trade agreement beween Mexico, Colombia and Venezuela; and the bilateral deals between Chile and Mexico; Mexico and Costa Rica; Chile and Venezuela; Colombia and Venezuela; and El Salvador and Guatemala.

4 In practice, the Andean Pact and the Central American Common Market have found it extremely difficult to implement a common external tariff. The G-3 free trade agreement scheduled to start in January 1995, in turn, was indefinitely suspended after the Mexican foreign exchange crisis of December 1994.

5 Yet the approach used by NAFTA to define rules of origin is less transparent than that used by the Latin American Integration Association (LAIA). NAFTA's rules of origin are expanding throughout the region as Mexico has negotiated bilateral or minilateral agreements with other LAC countries.

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Novelty No. I: US "Regionalism" Reconsidered

The United States was the champion of multilateralism for most of the postwar period. Yet discrimination was not completely absent from its trade policies. In effect, the US encouraged or tolerated preferential trade agreements (such as the EEC) and even directly took part in discriminatory arrangements such as the Auto Pact with Canada, the Generalised System of Preferences, the Caribbean Basin Initiative, or the US-Israel Free Trade Agreement. Yet in all these cases discrimination was generally subordinated to security considerations and the "most favoured nation" (MFN) principle.

But neither CUSFTA nor NAFTA can be adequately understood on purely foreign policy or strategic grounds. In effect, the basic thrust behind the US drift towards preferential liberalisation with Canada and Mexico was economic. On the US side, CUSFTA was brought about by growing US (particularly Congressional) dissatisfaction with the evolving multilateral trade regime. The modest results achieved in the Tokyo Round of multilateral trade negotiations and the difficulties to make substantial progress in the early years of the Uruguay Round, stimulated a bilateral approach to advance US trade interests. The passage of the European Unification Act in 1986 and the fears of "Fortress Europe" may have also influenced the US policy stance. Growing Congressional activism in trade policymaking also supported discrimination and bilateralism: in effect, since the mid-1970s each new trade legislation has emphasised the use of unilateral and bilateral mechanisms to promote US trade objectives.[6] NAFTA further reinforced these trends.

Although so far more rhetorical than substantive, the launching of the Enterprise for the Americas Initiative in 1990 and the Miami presidential summit of December 1994 have been new indications of the same trend. The former set forth the idea of a hemispheric free trade area, of which NAFTA would be the founding-stone. The Miami presidential summit, in turn, led to the commitment to conclude negotiations to launch a hemispheric free trade area by the year 2005. Yet the US interest has not been confined to LAC: in the presidential summit held in Bogor (Indonesia) in late 1994, APEC members committed themselves to establish a free trade area by the year 2015.

6 The 1974 Trade Act instructed the President to negotiate bilateral trade agreements if these could be shown to enhance US trade interests. The 1979 Trade Agreements Act requested that the President carries forward a study to assess the desirability of negotiating trade agreements with other North American countries. The 1984 Trade and Tariffs Act authorised the President to negotiate a free trade agreement with Israel and other countries under a fast-track authority. This authority was renewed by the 1988 Omnibus Trade and Competitiveness Act.

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Novelty No. II: Unilateral Trade Liberalisation in LAC

In the 1990s preferential arrangements among LAC countries have developed against a background of unilateral trade liberalisation. Furthermore, unilateral trade liberalisation was frequently carried out jointly with ambitious economic reforms involving the foreign exchange regime, international capital movements, the role of the market in resource allocation, and the extent of public intervention in the economy. The juxtaposition of unilateral and preferential trade liberalisation has made the prospect of preferential arrangements more favourable than at any other time in the past.

Three factors contributed to the change of policy paradigm in LAC: (i) the structural transformation of the international economy brought about by rapid technical change and the globalisation of markets and production; (ii) the growing inability of import-substitution industrialisation to foster economic growth and macroeconomic stability; and (iii) the large negative external shocks of the early 1980s.[7] The need to obtain external resources to overcome the financial constraint brought about by the debt crisis reinforced the role of international financial institutions in homogenising trade policies throughout the region.

These imperatives combined – and gave *ex-post* rationale – to the idea that in the new environment of rapid technical change, far-reaching internationalisation of production and domestic economic fragility, sustained export and output growth demanded the dismantlement of protection and the promotion of an open pattern of integration into the world economy. Low savings and investment rates, a heavy external debt burden and persistent balance of payments imbalances also contributed to change the perspective about the marginal contribution which foreign direct investment could make to economic growth and increased tradeability.

This new environment is a key to understand the uniformity with which import-substitution industrialisation turned into generalised (although not necessarily sustainable) liberalisation of trade regimes. In the early 1990s the process was fuelled by changing conditions in international capital markets and by renewed availability of external finance, which contributed to close the gap posed by large trade and current account deficits. With differences in rhythm or intensity, this story is common to all LAC countries.[8]

In this environment, and in contrast to the traditional objective of widening protected domestic markets to benefit from economies of scope and scale, the new thrust of economic integration throughout the region was to improve access to world markets by facilitating industrial restructuring and

7 Bouzas and Ffrench-Davis, 1995.

8 Of course, NAFTA itself is a testimony of unilateral trade liberalisation in LAC.

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increasing host countries' attractiveness to foreign direct investment. Overall, most arrangements have conformed to the pattern of "open regionalism" and, as such, protection vis-à-vis the rest of the world has not been raised.

Yet these attributes and the rhythm of progress of each preferential arrangement have varied widely. In effect, a number of pre-existing agreements, such as the Latin American Integration Association (LAIA), the Andean Pact or the Central American Common Market, have made almost no substantial progress. Similarly, some of the most recent preferential arrangements have not gone beyond formal commitments. Some have taken place among countries which can hardly be regarded as "natural" trade partners, or between countries which do not display (even the potential for) significant trade interactions. Indeed, the proliferation of preferential trade arrangements among LAC countries in the early 1990s may not be efficiency-enhancing.

II NAFTA and Mexico: An Overview

One of the major features of the revival of preferential trade agreements in the Western Hemisphere has been the emergence of a "North-South" variety of economic integration. NAFTA is the first preferential and reciprocal trade arrangement between a developed and a developing country. Its implementation has thus been accompanied by lively debates about the potential implications for partner countries.

It is generally accepted that to assess the impact upon member countries of a preferential liberalisation arrangement is both difficult and uncertain. In effect, received economic theory concludes that in a second-best world and from a static standpoint, preferential liberalisation enhances participants' welfare only if trade creation is larger than trade diversion. Yet allocative net gains are far less important than the "dynamic effects" which come from economies of scale, enhanced competition, technological diffusion, diminished uncertainty and changes in the location and/or volume of real investment.[9]

Furthermore, since NAFTA does a lot more than just reducing tariffs and removing non-tariff barriers (such as introducing new parameters for intellectual property protection, foreign investment policies, trade in services, and environmental and labour standards), an assessment of costs and benefits is further blurred. Ultimately, any assessment in these contentious areas will be to a large extent dependent upon the strength attributed to convergence versus polarisation effects.

9 The classic presentation is in Balassa (1961). See also El-Agraa (1989).

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The issue does not end there, though. Since history matters, the final result will not be independent of the path of trade liberalisation and the environment in which it takes place. This creates strong linkages not only between the final effect of the agreement and the pace of trade liberalisation but, more importantly, between the former and the prevailing macroeconomic environment.

NAFTA and Mexico: Quantitative Assessments

Lustig[10] provides a comprehensive survey of available applied research on the effects of the elimination of tariff and non-tariff barriers to trade between Canada, Mexico and the United States. Available estimates generally show that the direct impact on Mexico's real income is positive but small, and that it ranges from one-third of one percentage point to over three per cent. The result depends on the assumptions made about technology (constant or increasing returns to scale), market structures, or the static or dynamic character of the model.

The reason for such limited effects is straightforward. Mexico was already a relatively open economy at the time of the agreement and its exports faced relatively low tariffs in the US market. Hence it comes as no surprise that estimated allocative effects are relatively minor.

Computable general equilibrium models incorporating the effects of capital inflows and the evolution of domestic interest rates anticipate a larger impact on Mexican real incomes (between five to eight per cent). Yet this magnitude remains modest and is tantamount to less than three years of GDP growth, even if the relatively slow growth of the 1989-1993 period is taken as the bench-mark.

Given comparatively higher protection and import elasticities in Mexico, Mexican trade deficits vis-à-vis the United States are also likely to grow in the short to medium term. It is certainly early to draw any solid conclusions about the impact of NAFTA on trade flows only slightly over a year since its implementation. Yet two-way US-Mexican trade flows have been expanding rapidly in the recent period.

Beyond Trade Effects

Whatever the conclusions about the trade effects of lower border barriers to trade are, NAFTA goes well beyond the removal of tariff and non-tariff

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10 Lustig, N., "NAFTA: Potential Impact on Mexico's Economy and Beyond", In: R. Bouzas and J. Ros (eds.), *Economic Integration in the Western Hemisphere*, Notre Dame: Ill., University of Notre Dame Press, 1994.

barriers. In effect, it has been argued that the most important effects of NAFTA will come from its confidence-enhancing impact, its stimulus upon discontinuous productivity growth and, more broadly, the accelerated pace towards modernisation and institutional convergence which the agreement will bring forward for Mexico. That the effect of NAFTA will go well beyond trade is reaffirmed by the fact that it includes commitments concerning trade in services, foreign investment practices, government procurement, intellectual property rights and, indirectly, environmental and labour standards.

The confidence-enhancing impact of NAFTA is linked to the familiar "lock-in" effect. The case was made that NAFTA will make it harder to reverse the market-oriented economic reforms put forward by the Mexican governments since the mid-1980s. Policy stability and predictability will be more effectively guaranteed by a contractual agreement with an influential partner, such as the United States.

Enhanced policy credibility may in turn lead to larger foreign investment inflows, higher investment rates and faster long-term economic growth. It is noticeable that the interest of the Mexican government in negotiating a free trade agreement with the United States followed its failure to significantly improve Mexico's current account position after the Brady debt reduction agreement. In effect, debt accumulation and structural reforms in the 1980s widened the current account deficit required to maintain historic rates of GDP growth. The 1989 Brady agreement made no substantial contribution to solve this basic conflict. A Free Trade Agreement (FTA) with the US was hence perceived as a positive contribution to finance the current account imbalance. Even if trade deficits were expected to grow in the short run as a result of trade liberalisation, sizeable capital inflows would help to sustain higher rates of economic growth. Furthermore, if capital inflows were geared towards productive investment, Mexico's ability to earn foreign exchange in the future would be strengthened.[11]

The size of NAFTA's contribution to large shifts in productivity growth has also been subject to debate. Lustig[12] has argued that this may have been one of the most significant incentives for Mexico to enter NAFTA. However, based on the post-1985 trade liberalisation experience, Ros[13] is less confident that trade liberalisation per se will make a significant contribution to faster productivity growth.

Indeed, if large discrepancies in per capita incomes prevail among the partners of a preferential trade agreement (and the same applies to unilateral

11 In contrast to portfolio flows, Ros (1994) found that foreign direct investment did not respond in anticipation to NAFTA. See also Dornbusch and Werner (1994).

12 Lustig, 1994.

13 Ros, 1993.

liberalisation policies), the presence of externalities derived from economies of agglomeration and the interaction between economies of scale and "natural" trade barriers (such as transport costs) may open the door to cumulative processes of expansion or decay.[14] If "vicious" and "virtuous" cycles play an important role, economic analysis can provide only partial a priori answers as to the final outcome. Since the distribution of costs and benefits within the economies is likely to be uneven as well, this is likely to reinforce divergent patterns of economic growth and development.[15]

This debate is linked to the broader issue of the desirability of institutional convergence among largely disparate countries. Arbitrage between widely different institutions and practices is generally difficult. Furthermore, convergence is not necessarily desirable.[16] Although raising the judiciary's standards may contribute to enhance economic performance (through stronger and more predictable enforcement of property rights), the same conclusion does not apply to areas as diverse as environmental or labour practices.[17] "Imperial harmonisation" need not be an optimal course of action when large disparities are the rule.[18]

In sum, the direction and size of the more important but less tractable dynamic effects are uncertain. It is hence important to emphasise that strong conclusions frequently draw more heavily on philosophical, political and/or ideological principles than on solid analytical and empirical evidence.

Path Dependency and the Macroeconomic Environment

Assessment of NAFTA's impact is further complicated by the fact that history matters. Hence, the final outcome will not be independent of the pattern of trade liberalisation and its environment. This implies a strong linkage between the effect of the agreement and the prevailing macroeconomic environment.

We have argued that one of the Mexican incentives to enter an FTA with the US was the desire to attract foreign investment, finance a large current account deficit, and hence overcome the external financial constraint typical

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14 For a discussion see Krugman and Venables (1992).

15 This issue has been raised in reference to the uneven impact of NAFTA within Mexico. Given prevailing disparities in income levels, NAFTA may have a positive agglomeration effect upon "high-incomes Mexico" (the central and northern regions of the country), while the "low-income" areas of the south witness the incomes gap widen.

16 See de Melo, Panagariya and Rodrik (1992).

17 Even in the case of intellectual property rights, there is no conclusive evidence that a high standards protection stimulates investment.

18 For a discussion of the "imperial harmonisation" scenario see Lawrence, Bressand and Ito (1995).

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of the 1980s. Yet a case can be made that by stimulating capital inflows in the 1993-94 period, NAFTA contributed to maintain an otherwise unsustainable policy mix. Similarly, the interest of not placing obstacles to the passage of NAFTA in the US Congress may have stimulated the maintenance of an exchange rate policy which was inconsistent with the Mexican economy fundamentals and, in particular, with an expansionary monetary policy such as that implemented in 1994 under the pressure of the domestic political cycle.[19]

Krugman[20] discusses these issue more broadly in the context of EEC enlargement. He argues that the bullish expectations of financial markets brought about by Spain's accession to the EEC bore little relationship to an appropriate exchange rate from the standpoint of current account sustainability. Thus the importance of "getting the exchange rate right" at the time of entry into an FTA agreement is underlined: if stable exchange rates are to provide a gain in terms of diminished uncertainty and the integration of capital markets, it is important that there is no sharp misalignment in the first place, and that whatever misalignment exists is not aggravated by "misled" financial expectations.

Among the casualties of the Mexican foreign exchange crisis of late 1994 is the idea that macroeconomic consistency was a prerequisite for FTA negotiations with the US. Although macroeconomic stability is certainly a contributing factor to sustainable and successful liberalisation (whether preferential or unilateral), the Mexican crisis showed that considerations other than macroeconomic consistency were far more important than objective criteria to engage Mexico in NAFTA. Yet although it is difficult to find any direct link between NAFTA and the Mexican foreign exchange crisis, the former was instrumental in inducing the emergency package put forward by the US Treasury in early 1995. With NAFTA in place, Mexico is also likely to be better prepared to administer the tensions which rapid export growth to the US market may bring in the future, as compared to what might have been the case in the absence of a preferential agreement.[21]

19 It is interesting to note that the whole debate about macroeconomic stability and "indicators of readiness" ended up as being conspicuously misleading. Mexico was generally regarded as the prime candidate to enter into a free trade agreement with the United States and it received high marks in a "readiness indicator" popularised by Schott and Hufbauer (1994).

20 Krugman (1992).

21 It will be interesting to see how the US interest on (or political receptiveness for) free trade negotiations with other LAC countries will be affected by the expected sharp contraction of the US trade surplus with Mexico to be brought about by the peso devaluation.

III NAFTA and the Rest of the LAC Countries: Implications and Policy Dilemmas

Most quantitative estimates conclude that NAFTA will have only a small impact on the rest of the world, particularly among the LAC countries. Yet these conclusions are based on what can readily be measured: static trade effects. Erzan and Yeats[22] estimate that NAFTA will reduce LAC exports to the US by just 0.7%.[23] Another estimate shows that 94% of NAFTA's trade diversion will affect extra-regional exports: only the remaining 6% will impact LAC exports (tantamount to as little as US$28 million).[24] However, these empirical estimates, important as they are, miss many of the significant effects of NAFTA on the rest of the world, and particularly the LAC countries.

Indeed, for the Central American and Caribbean countries, the implementation of NAFTA has radically changed their external environment. Yet the absolute value of trade flows potentially affected is minuscule by world (or even hemispheric) standards. The fact that the conditions of access of Central American and Caribbean countries to the US market have deteriorated *relative* to those of Mexico is more serious, due to the fact that throughout the 1980s many of these countries' trade and foreign investment flows were heavily influenced by the non-reciprocal preferences granted by the United States through the Caribbean Basin Initiative. Erosion of these preferences may thus have a severely disruptive impact upon trade and investment flows.[25]

More generally, even for countries for which NAFTA did not have significant immediate effects in terms of either trade or investment diversion, its implementation and potential expansion became an unavoidable fact in policy planning, if not in policy making. This was certainly the case for Brazil and, more generally, the Mercosur countries.

For the rest of the LAC countries, the costs and benefits of NAFTA can be qualitatively assessed taking into consideration three broad issues: (i) the heterogeneous structure of national "positive" *(per se)* incentives for preferential trade liberalisation vis-à-vis the United States; (ii) the divergent "defensive" motivations posed by NAFTA and its potential widening; and (iii) the prevailing uncertainty as to future "entry fees".

Heterogeneous "Positive" Incentives

LAC countries differ considerably in terms of their trade patterns (both as

22 Erzan and Yeats (1992).
23 See Primo Braga (1992).
24 See Erzan and Yeats (1992).
25 See Martin, Messina and Taylor (1994).

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regards commodity and regional trade structures), economic structures and localisation advantages vis-à-vis the largest hemispheric market. This gives rise to an extremely heterogeneous structure of "positive" incentives to participate in preferential trade arrangements with the United States.[26]

Considering only the preferential components of discriminatory trade arrangements, LAC countries can be grouped into four categories according to the extent and nature of their trade links with the United States: (i) "natural" trade partners primarily exporting commodities (some Central American and Caribbean countries, Colombia, Venezuela and Ecuador); (ii) "natural" trade partners with a relatively high share of manufactures in total exports (some Central American and Caribbean countries and, certainly, Mexico); (iii) countries with geographically diversified trade patterns primarily exporting commodities (Bolivia, Chile and Peru); and (iv) countries with geographically diversified trade patterns with a relatively high share of manufactures in total exports (the Mercosur countries). Each of these categories will have divergent "positive" incentives to enter into preferential trade arrangements with the US.

From a static standpoint, this uneven distribution of benefits is illustrated by estimates by Erzan and Yeats,[27] which confirm the key role of geographical trade structures in determining the potential for export expansion. These estimates show that the largest beneficiaries of preferential access to the US market (in relation to total exports) are Mexico and the Central American and Caribbean countries (which display a high concentration of trade flows with the United States).

The same estimates also illustrate the role played by the commodity composition of exports. US trade barriers to certain manufactured imports and the relatively high concentration of exports in those types of manufactures explain why for some LAC countries which export a large share of manufactures to the US (such as Brazil), the benefits are relatively larger than for US "natural" trade partners which are primarily exporters of primary products (such as Venezuela and Ecuador). There is no reason why net dynamic gains will not be unevenly distributed as well. Indeed, a strong case can be made that they would probably be more unevenly distributed than static trade effects.[28]

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26 "Positive" (as opposed to "defensive") incentives to enter into negotiations can be analytically disaggregated into three components: (i) trade liberalisation (reduction or elimination of protection to domestic producers); (ii) market access (better and more secure access to the partners' market); and (iii) trade diversion (substitution of low-cost third country suppliers). The latter two are peculiar to preferential liberalisation, whereas the first one exists in any trade liberalisation process. For a more thorough discussion see Bouzas and Ros (1994).

27 Erzan and Yeats (1992).

28 Differences in economic structures, localisation advantages, regional trade and investment patterns and size will be decisive in influencing the size and direction of net dynamic gains.

If the unilateral trade liberalisation component of preferential arrangements is taken into consideration (particularly the thorny issue of transition costs), the uneven distribution of "positive" incentives is further strengthened. Given the prevailing differences in LAC levels of protection and macroeconomic environments, transition costs will result in divergent assessments of the "positive" incentives of entering preferential trade negotiations with the US.

"Defensive" Incentives

Beyond the "positive" *(per se)* incentives to enter preferential negotiations with the United States, countries may have strong "defensive" motivations to take part in discriminatory arrangements to avoid the costs of exclusion. As far as NAFTA is concerned, most "defensive" incentives for those excluded stem from the fact that the United States is a large market for exports and a significant source of foreign investment. Preferences granted to Mexico erode existing preferences (such as those of the Andean Trade Preferences Act, the Caribbean Basin Initiative or the Generalised System of Preferences) or introduce new sources of discrimination.[29]

Since the costs of discrimination rise as the number of participating countries grows, "defensive" incentives for those excluded will increase as agreements proliferate or widen. Furthermore, if North-South preferential arrangements extend to countries which are active participants in intra-regional trade (in contrast to Mexico), "defensive" considerations will stem from deteriorating access conditions not only to the US market, but also to the markets of other neighbouring countries which may be "natural" trade partners of those excluded.[30]

Yet "defensive" incentives may stem not only from trade considerations but also from broader influences. In particular, in so far as NAFTA was regarded as a "seal of approval" of domestic policies and as a positive signal to foreign investors, being left out or not being part of the shortlist of prime candidates may have a price in terms of financial markets' expectations. Although this may not have been worrying when external finance was abundant, it may turn out to be a relevant factor as external finance dries up and selectivity (not necessarily based on sound economic judgement) becomes more influential in determining capital flows.[31]

In short, "defensive" motivations can give rise to incentives and policies which may not be grounded on economic efficiency or distributional consid-

29 Available evidence suggests that Brazil and the Central American and Caribbean countries are likely to be the most adversely hit by Mexican preferences in the US market.

30 Chile and Mercosur may be cases in point.

erations. Furthermore, since market power in the hemisphere is extremely heterogeneous, "defensive" motivations can further rumple the playing field.

Uncertain "Entry Fees"

The intensity of "defensive" motivations is likely to influence "entry fees". Since the latter are uncertain, they may vary according to the size of the costs of exclusion for those left out of an expanding NAFTA. Rising exclusion costs could even create incentives for discriminated countries to pay "entry fees" prior to engaging in an agreement, and simply to launch negotiations.[32] This fact would severely weaken the bargaining position of discriminated countries and could turn out to be a source of friction and resentment.

Since "entry fees" partly relate to areas in which there is no pre-existing international agreement or in which differences in levels of development or societal preferences may place obstacles to convergence, uncertainty about their content and evolution may be particularly burdensome.

One of the reasons why multilateral trade arrangements are superior to preferential agreements is precisely because those wanting to take part know beforehand the price of membership. Uncertain and variable "entry fees" are an extremely negative feature, particularly in an environment in which very asymmetrical market power structures prevail.

IV LAC Responses to the NAFTA Challenge

The previous discussion helps to understand why the establishment of NAFTA was a key issue for LAC trade strategies in the early 1990s. This importance was reinforced by the fact that unilateral trade liberalisation policies had led to an environment that was more conducive to negotiating preferential trade arrangements with Northern partners. It is evident that in the context of the inward-oriented economies of the 1960s and 1970s, the idea of an FTA with the United States would not have merited consideration.

Even before NAFTA was in place it had a significant impact upon LAC

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31 There is evidence that the Argentine government's enthusiasm to enter into preferential trade negotiations with the United States purported to enhance domestic and foreign investors' expectations and, particularly, reduce the country-risk premium. In this context, the fact that Chile (generally regarded as a successful reformer) was first in line to negotiate with the US was regarded as a negative signal upon investors' expectations. These considerations placed Mercosur under great strain in the final phase of the negotiations.

32 Many of the implicit and undefined conditions to be a candidate to enter into NAFTA may open the door for such "advanced" payments. As a result of the Miami presidential summit, the US Trade Representative (USTR) is putting forward a strategy of advancing faster in areas such as government procurement, intellectual property protection and foreign investment, even before market access issues are dealt with at length. See USTR (1995).

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countries. The news about the US-Mexican negotiations to create an FTA in early 1990 influenced several LAC countries' decision to accelerate trade liberalisation. Similarly, it stimulated a revival and deepening of intra-LAC preferential trade arrangements.[33] Although it is hard to demonstrate clear causal relations, expectations raised by NAFTA negotiations and its potential widening exerted their influence throughout the region.

It is noteworthy that since the Enterprise for the Americas Initiative was launched, the number of preferential agreements in LAC multiplied while others deepened. Two stylised approaches have emerged in the process.[34] On the one hand, a large number of countries have fostered the negotiation of FTAs. On the other, some existing regional integration initiatives have been deepened. Overall, two groups of countries were particularly active in the process. Mexico and Chile are typical of the first approach: both countries were active in negotiating FTAs with other Latin American partners. The other group is composed of the Mercosur countries: although clear tensions prevailed within the group as to its final shape, Mercosur's course of action was to deepen their own regional agreement instead of going for multiple and simultaneous negotiations with third parties.

Overlapping Free Trade Agreements

Many LAC countries have been active in negotiating bilateral preferential agreements in the early 1990s, yet two outstanding cases are Chile and Mexico. Since the Enterprise for the Americas initiative was launched, Mexico has concluded FTAs with Chile, the United States and Canada, Colombia and Venezuela, Costa Rica and Bolivia. Chile, in turn, signed FTAs with Venezuela, Colombia and Mexico, and it is expecting to enter negotiations to accede to NAFTA in the course of 1995. Other countries which are part of subregional trade arrangements (such as the Andean Pact or the Central American Common Market) also signed bilateral or minilateral agreements, including those between Colombia and Venezuela; and Honduras, Guatemala and El Salvador.

The incentives of Mexico to carry negotiations beyond NAFTA were twofold. The first was to consolidate its position as the hub in a network of trade arrangements in which Mexico's preferential access to the largest market in the Western Hemisphere placed it at an advantage vis-à-vis all its

33 Many bilateral initiatives followed the announcement of US-Mexican negotiations. The Argentine and Brazilian governments (which had been advancing a bilateral process of integration since the mid-1980s) also decided to launch Mercosur incorporating Paraguay and Uruguay and mapping the road towards a customs union.

34 A third road is the Central American and Caribbean efforts to upgrade the Caribbean Basin Initiative to match the benefits which NAFTA granted to Mexico.

trade partners.[35] The second was to reduce uncertainty about the potential effects of divergencies in the enforcement of LAIA article 44, which established that all members should extend to other partners the preferences granted to extra-regional countries.

For Mexico's partners the incentives were also twofold: (i) to avoid the erosion of preferential access to the Mexican market as a result of NAFTA (whenever these preferences existed); and (ii) to find an "indirect" access route to NAFTA. The latter was frequently mentioned as the main Colombian and Venezuelan incentive to join Mexico in the Group of Three.[36]

Chile was also active in promoting FTAs with other LAC countries, hence maximising its trade policy independence. Chile had abandoned the Andean Pact in the 1970s and (once Mexico had entered NAFTA) Chile was left as the only LAIA country which was not a member of a subregional agreement. Although the Mercosur countries had invited Chile to join the customs union in the 1991-94 transition period, discrepancies on tariffs prevented this from taking place.[37] Chile (as well as Mexico) also became a member of APEC.

It has been argued that since FTAs do not restrict member countries' freedom of action to shape their trade policies vis-à-vis the rest of the world, they have a liberal trade bias. Furthermore, pressures stemming from trade and investment deflection (though they can be partly overcome by strict rules of origin) could stimulate the more "protectionist" country to open up.

Furthermore, it has been argued that since FTAs do not commit members to a common external policy, they may be widened by unilateral decision, and hence be more conducive to the multilateralisation (or "minilateralisation") of preferences. Yet in the absence of a coordinating mechanism (solid multilateral arrangements or an influential partner) the outcome can be quite different: a series of casuistic and eventually contradictory agreements which hinder rather than facilitate multilateralisation (or "minilateralisation") of preferences. In effect, each participant will have an incentive to become the hub of a hub-and-spoke system.

Overlapping preferential trade arrangements, although at first sight they could be regarded as steps towards more open trade regimes, could in fact turn out to be an extremely inefficient scenario, particularly if each has its own exceptions and rules. On the one hand, there is a risk of spending scarce resources on administration and transport. On the other, such an environment is likely to prove more conducive to the operation of interest groups.

35 Wonnacot (1991) discusses thoroughly the trade and investment incentives to become a hub.

36 It is hard to understand the basis of such argument.

37 In an article tailor-made for Chile, the Asunción Treaty signed in 1991 by the four Mercosur countries established that accession would be open to all LAIA members after a period of five years, except for countries not being part of other subregional endeavours.

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Furthermore, an uncoordinated process can even lead to contradictory and/or incompatible rules.

In practice, this scenario may be taking place as a result of the proliferation of FTAs in the Western Hemisphere. If this were the case, preferential liberalisation may end up being detrimental rather than instrumental to "open regionalism". Although there may be a trend towards more homogeneous rules across FTAs in the Western Hemisphere, this is by no means assured. An example is provided by alternative approaches to rules of origin: NAFTA has adopted specific rules of origin as compared to the relatively more transparent LAIA pattern. Yet all new intra-LAC preferential trade agreements in which Mexico has taken part since entering NAFTA (such as the Group of Three) had to incorporate NAFTA rules of origin. This may well be considered as a step backwards in transparency and low-cost administration.[38]

Although the Uruguay Round Understanding Agreement on Article XXIV and the renewed WTO dispute settlement mechanism may improve multilateral disciplines, it is uncertain whether they will be enough to bring under control the most negative trends deriving from the proliferation of overlapping agreements in the Western Hemisphere. It is desirable that stronger disciplines be implemented at the hemispheric level.

The Customs Unions Approach

Mercosur countries have followed an alternative strategy. In effect, the Asunción Treaty signed in 1991 established a four-year transition period to complete a free trade area and to agree on a common external tariff (CET). In December 1994 the Ouro Preto protocol gave birth to the customs union, which was implemented as scheduled in January 1995.[39]

In contrast to free trade areas, customs unions commit member countries to a common external trade policy. The conventional case in favour of customs unions vis-à-vis free trade areas is based on the lower administrative costs which stem from the elimination of rules of origin.

From the standpoint of participating countries, a customs union also ensures that the cost-benefit balance achieved at the outset of the agreement is not altered by unilateral action (short of breaking up). Customs unions also "protect" existing intra-regional trade flows, contributing to a more stable incentives environment for private firms. The customs union also limits the influence of "defensive" incentives which stem from uncertainty about the

38 The Inter-American Development Bank is carrying forward an exhaustive research on rules of origin in all preferential trade arrangements in the Western Hemisphere. Its conclusions will be highly illustrative as to the problems of compatibility.

39 For a detailed review of the process see Bouzas (1995).

actions of "natural" trade partners. Customs unions stabilise market access conditions *relative* to the rest of the world.

Yet customs unions are much more difficult to negotiate and implement because they are more demanding in terms of the range of instruments to be harmonised. To start with, a customs union demands agreement on the level and structure of the CET, which at times may be difficult to achieve. Moreover, in the case of Mercosur, divergent attitudes as to the negotiation of a preferential trade agreement with the United States further complicated the issue.

Given the different national perspectives about entering preferential negotiations with the United States, prior to the implementation of the customs union in January 1995 there was considerable speculation as to its prospects. The issue was of secondary importance for Paraguay and Uruguay, where public attention and bureaucratic energies were clearly geared to the much more relevant process of integration in the subregion. Yet in the two largest partners official attitudes differed markedly. Whereas the Argentinean government was enthusiastic about the idea of negotiating an agreement with the United States, the Brazilian official perspective was generally more sceptical. At one point, divergencies between the two largest partners threatened to impair progress towards the customs union.

The divergent nature of Mercosur incentives to negotiate an FTA with the United States can be explained on several grounds. For the smaller partners, the main issue at stake was liberalisation of the subregional market. Their main incentive vis-à-vis the United States was defensive: to make sure that preferences in the subregion are not unilaterally eroded. For Brazil the balance is different. Brazilian exports are likely to benefit most in terms of market access from preferential trade liberalisation vis-à-vis the United States. Brazil is also the country which would be most adversely hit by trade diversion in the North American market as a result of NAFTA. Brazilian exports may also suffer in LAC markets if NAFTA expands to other countries in the region, particularly in South America.[40]

For Argentina, market access to the United States is not a key issue, yet the "enhancement of expectations" and lock-in effects of a NAFTA-type agreement may have played a key role in official attitudes. It is also likely that the objective of strengthening the bargaining position vis-à-vis Brazil in the final stage of negotiations leading to the customs union also contributed to a generally more sympathetic Argentinean stance.

40 Furthermore, Brazilian reluctance to enter into negotiations with the US and/or NAFTA stems from the generalised perception that adjustment and macroeconomic issues posed by trade liberalisation have not received adequate attention in NAFTA, and that they are unlikely to do so in the future. See da Motta Veiga (1995.

But implementation of the customs union as of January 1995 placed this issue aside, at least temporarily. It also posed the imperative to renegotiate Mercosur bilateral preferences with other LAIA members. Eventually, all bilateral preferences will have to be consolidated for the customs union to levy a common tariff on imports from other LAIA partners.[41] In mid-1994 the Brazilian government also proposed negotiations to create a South American Free Trade Area (SAFTA), aimed at the convergence of Mercosur, the Andean Pact and Chile. Renegotiating preferences within LAIA partners could be a first step in this direction. Yet experiences so far suggest that the process will advance slowly.

V Conclusion: Which Way towards Hemispheric Integration?

We have argued that since history matters, process and method will not be irrelevant to the final shape and effects of the "regionalist" revival in the Americas. The asymmetrical balance of market power, heterogeneous positive incentives to enter FTA negotiations with the United States, non-negligible "defensive" incentives, and uncertain "entry fees" will leave their mark on the process.

Economic integration in the Western Hemisphere will advance, if at all, in an extremely uneven fashion. Thus the most likely scenario is one of slow progress, with coexisting and overlapping integration schemes. In this context, although an environment of low protection vis-à-vis the rest of the world is a prerequisite for "open regionalism", this is likely to be insufficient to prevent "defensive" motivations from exerting disruptive effects on trade policies and trade and investment flows in the region.

Thus preferential trade arrangements in the Western Hemisphere, and particularly those with the largest potential to disrupt trade and investment flows or trade policies in the region, should include explicit and transparent access rules.[42] As the largest preferential trade agreement in the hemisphere,

41 Mercosur has made an offer to its LAIA partners except Mexico (Mexico has to negotiate compensations for not extending preferences granted to NAFTA members) which consists of: (i) a "multilateralisation" of pre-existing bilateral preferences (unless there is an explicit opposition from one Mercosur partner); (ii) a minimum 40% generalised preference for the remainder; (iii) a chronogram to increase automatically and linearly preference margins; (iv) a list of exempted products and a phase-out calendar; (v) a list of sensitive products to receive a preference lower than the minimum (30%) for a period of three years; (vi) an agreement on rules of origin, safeguards, dispute settlement, duty-free zones, customs valuation, export incentives, special customs regimes, harmonisation of technical and sanitary standards and unfair trade practices; and (vii) automatic extension of benefits negotiated with extra-regional members (MFN clause).

42 Explicit and transparent access conditions need not be generous. The objective of transparency should be to reduce discretion, at least in the pre-negotiation and negotiating phase, and not necessarily to facilitate accession.

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this would demand clear access rules for NAFTA and, particularly, a clear US policy stance as regards the future of preferential negotiations in the region. As long as this is lacking, preferential liberalisation is in danger of bringing about conflict and resentment.

Leaving aside the emergence of an inefficient hub-and-spoke system, two broad avenues are open to expand "regionalism" in the hemisphere.[43] One is successive accessions to NAFTA. Whether this will take place or not will to a large extent depend on the US resolve to widen NAFTA. The sheer size of the US market is likely to be a decisive gravity force for the LAC countries, especially for those in the central and northern parts of the hemisphere. Defensive incentives to join would then start to weigh heavily in the southern part of the continent. In this scenario, a strong US commitment and leadership is the prerequisite for progress.

Some have argued that since North-South agreements provide more benefits for participating (especially developing) countries because dynamic effects may be more important than in South-South arrangements, this alternative should be emphasised.[44] Yet this conclusion depends strongly on NAFTA's being an appropriate model of North-South agreements, and this is debatable. The NAFTA approach includes no explicit mechanism to compensate for adjustment costs in the developing partner and, ultimately, it believes in the strength of convergence as opposed to polarisation effects and in the positive role played by market forces in that process.[45]

An alternative would be the gradual convergence of existing trade liberalisation arrangements both in the Northern and Southern parts of the hemisphere. For this to take place, the Andean Pact and Chile should converge with Mercosur in a South American Free Trade Area (SAFTA). There are two main difficulties for this scenario to materialise. The first is the dense intra-regional agenda which Mercosur still has ahead. The second is that intra-South American trade flows (except for Mercosur and Chile) are still modest. Without solid positive economic incentives, it is difficult to anticipate sustained progress towards SAFTA, at least in the short term.

With both roads open and no clear way to proceed, the best contribution to deepen trade and investment flows in the hemisphere would be to strengthen the role of rules and transparency as opposed to discretion. If the post-Miami presidential summit process makes this sole contribution, its achievements would be far from modest.

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43 See Lipsey (1992) for another criticism of a hub-and-spoke system.

44 One reason would be enhanced credibility.

45 The US Treasury-sponsored Mexican rescue package could be regarded as a positive "side effect" of the preferential trade agreement.

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Comment on "Preferential Trade Liberalisation," by Roberto Bouzas

Jaime Ros

Roberto's paper deals with two major topics. One is the current institutional process of integration. The other is different and has to do with the real processes of economic integration, with the direction in which the real trends in trade and economic integration are moving. Roberto has dealt very comprehensively with the first topic, in particular with the issues raised by NAFTA and the institutional processes associated with NAFTA. I have little to add on this subject. What I want to do is to focus on the second topic and make some suggestions to strengthen the comparison between the two processes, the "real" and the "institutional" trends in regional integration.

I want to begin by focusing on table 2 of Roberto's paper[1]. This table (see below) presents the actual trade intensity indices in 1990 and the trends in these trade intensity indices over the past 15 years before 1990. Consider now the following exercise. Define as natural trading partners those pairs of countries which have a trade intensity index of 3 or more on both the export and the import sides. A country with a trade intensity index of 3 with respect to another is one that is exporting to that country three times more than what one would expect from the shares of exports and imports of both countries in the world market. So the higher the index the more dense, the more intense are the trading relationships. Taking this value of 3 or more as defining natural partners is a bit arbitrary, but I don't think that reasonably different values would greatly affect the conclusions of the exercise.

One can then make a list of the pairs of countries which have a trade intensity index of 3 or more. Having done that, use this information to construct a two-by-two matrix as follows. The two rows separate countries according to the number of natural trading partners in the hemisphere. The first row includes those countries with a large number (5 or more) of natural trading partners in the hemisphere. The second row includes the rest, i.e. refers to those with a smaller number of natural partners. The columns separate countries according to whether they have the United States as a natural client. By this I mean that the US is not necessarily a natural trading partner but that,

1 Originally, this table was included in the draft version of Roberto Bouzas' paper; it is now reproduced here (see Table 1).

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Table 1 Trade Intensity Indices in the Western Hemisphere

	Argentina	Brazil	Canada	Chile	Colombia	Ecuador	Mexico	Peru	Paraguay	USA	Uruguay	Venezuela
Change in intensity (1965–90)												
Argentina	—	3.88	0.09	5.72	1.57	3.69	1.40	8.44	11.78	0.84	4.17	2.07
Brazil	-4.15	—	0.10	2.94	2.02	4.58	0.44	2.67	19.76	0.40	1.19	1.64
Canada	-0.32	0.13	—	0.21	0.14	-0.09	-0.57	-0.17	0.00	3.46	-0.08	-0.15
Chile	-0.55	3.65	0.16	—	3.95	4.37	-0.05	6.78	5.04	-0.23	3.55	0.67
Colombia	-0.02	0.36	-0.12	8.41	—	7.49	0.34	10.03	-0.40	1.36	4.01	5.91
Ecuador	-1.30	0.22	0.03	7.42	-7.65	—	0.13	43.54	-0.07	1.56	-2.14	1.30
Mexico	0.32	0.03	0.07	-1.43	0.45	1.48	—	1.58	6.37	2.71	1.74	0.57
Peru	-2.28	2.28	0.01	0.51	12.00	8.47	0.00	—	0.18	0.21	-0.55	2.94
Paraguay	-12.67	31.08	-0.08	10.28	0.51	-0.13	0.09	3.11	—	-0.95	-10.71	1.31
USA	-0.27	0.04	1.11	-0.36	0.59	-0.03	0.07	-0.38	0.46	—	0.06	0.23
Uruguay	11.16	25.89	0.16	2.51	-3.18	0.37	1.36	3.50	5.37	-0.06	—	0.17
Venezuela	-0.92	-2.52	-1.85	-0.75	9.60	-0.52	0.54	1.13	-0.04	3.03	4.16	—
Trade Intensity (1990)												
Argentina	—	11.07	0.17	13.46	2.88	3.97	2.08	13.87	21.30	1.17	38.65	2.41
Brazil	5.47	—	0.43	5.54	2.51	4.66	1.28	4.27	21.63	2.10	17.06	1.76
Canada	0.08	0.33	—	0.48	0.70	0.30	0.33	0.37	0.03	6.47	0.24	0.38
Chile	3.63	5.71	0.18	—	4.70	5.83	0.56	8.23	5.17	1.38	5.84	0.88
Colombia	1.07	0.43	0.26	8.72	—	12.81	0.48	12.11	0.08	3.79	4.45	6.23
Ecuador	0.95	0.23	0.07	10.28	5.76	—	0.32	46.77	0.19	4.52	0.99	1.34
Mexico	1.12	0.60	0.22	1.21	1.98	2.44	—	2.33	6.48	5.99	2.43	1.04
Peru	0.93	3.07	0.18	6.17	13.78	9.84	0.96	—	0.22	1.97	1.55	3.59
Paraguay	15.43	31.32	0.02	11.24	0.59	0.03	0.11	3.62	—	0.36	21.91	1.31
USA	0.81	1.26	5.41	1.52	2.59	2.06	5.89	1.86	1.23	—	0.66	1.68
Uruguay	12.92	28.71	0.20	3.52	3.53	0.62	1.56	4.66	6.83	0.81	—	0.20
Venezuela	0.10	0.40	0.02	0.55	9.71	1.51	0.55	1.69	0.09	4.84	0.50	—

Source: Primo Braga, Safati and Yeats, 1994.

at least from the side of the country's exports, the US is a natural partner, a natural client for the country's exports. The first column will thus include those countries which have the US as natural client. The second column will include the rest, those countries for which the US is not a natural client.

Thus, we have four boxes:

- In box 1, the North-West box, are those countries which have a large number of natural partners within the hemisphere and have the US as a natural client. Let me call this group of countries the "hemispheric" countries.
- In the second box, the North-East box, we have what one may call the "latinoamericanist" countries, i.e. countries which have a large number of natural trading partners within the hemisphere but for which the US is not one of them.
- Box 3, the South-East box, would be what – for lack of a better name – can be called the "sub-regionalist" group. These are countries which have a small number of natural trading partners and the US is not one of them.
- Finally, box 4, the South–West box, includes those countries which have few natural trading partners and the US is one of them, i.e. they have a very special trading relationship with the US. Call them the "bilateralist" countries.

Figure 1 Classification of Trading Partners

Hemispheric (Colombia)	**Latinoamericanist** (Chile, Uruguay)
Bilateralist (Canada, Mexico, Venezuela, Ecuador)	**Sub–regionalist** (Argentina, Brazil, Paraguay, Peru)

What do we learn from this exercise? Well, we find first that the group of "hemispheric" countries is almost empty. There is only one country in this box: Colombia, which has 5 natural partners and the US as a natural client. The second box, the "latinoamericanist" group, is also almost empty but not quite since there are two countries there. One is Chile, which has the largest number (7) of natural partners in the hemisphere but which does not have a special trading relationship with the US. The other "latinoamericanist" is Uruguay, also with a large number of natural trading partners in Latin America. Then, the "sub-regionalist" group includes, interestingly, 3 of the 4 Mercosur countries: Argentina, Brazil and Paraguay (Uruguay is not there because it is in the "latinoamericanist" group). Peru is also in this group, a country which has indeed few natural partners. This group thus largely overlaps with the Mercosur countries. Finally, in the "bilateralist" group, we find what one would expect, the NAFTA countries, Canada and Mexico, and two more countries, Venezuela – which has a special relationship through its oil exports with the US – and Ecuador which also, for similar reasons, falls into this box.

I think that the exercise is a reminder that geography matters very much indeed. Why is Colombia the only hemispheric country? Simply, perhaps, because it is in the Northern part of South America and, among the countries in this region, it is the one that has the most diversified export base. Thus, it is not surprising that it has a large number of natural partners in the hemisphere and that, because of its geographical location, it has also a special relationship with the US. Why are Chile and Uruguay the two "latinoamericanists"? A simple explanation is that they are two of the more open economies in the hemisphere – partly because they are small, partly because of their trade regimes. They tend to have a large number of trading partners, and being in the Southern Cone, very far away from the US, their natural partners are in South America. And if this is the explanation for Chile and Uruguay being the two "latinoamericanists", it suggests that the third group, the "sub-regionalist" countries, as it becomes more open and intensifies trading relationships with the rest of the hemisphere, is very likely, due to its geographical location, to become not necessarily "hemispheric", but rather "latinoamericanist" over time. It is likely that these countries will tend to move from the "sub-regionalist" box to the "latinoamericanist" box.

Two final points on the relationship between the institutional and real processes of regional integration. The first is that, independently of the institutional arrangements, the real processes of trade and economic integration are pointing towards the development of two major blocs in the hemisphere: the North-American bloc, on the one hand, extending from US, Canada and Mexico towards Central America and the Caribbean; and the South American bloc, on the other hand. Taking a very long-term perspective, it is very likely that these two blocs, the North-American and the South-American, will intensify their trading relationships over time and eventually become "hemispheric". This suggests, as an additional implication, that in this long process of hemispheric integration, natural hubs may be created in the process of integration. It is unlikely that Mexico will become a natural hub in the process of real integration. It is more likely that countries such as Colombia or the Central American countries perhaps – more generally, the Northern part of South America – will become in this long-term process the natural hubs of economic integration in the hemisphere.

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Floor Discussion of the Bouzas Paper

The approach that Jaime Ros took in his comment on Bouzas' paper raised the crucial question of whether one could really draw a clear distinction between 'natural' processes of integration, on the one hand, and 'institution-driven' processes, on the other. History and geography are important 'natural' factors, but aren't they, to a certain extent, reversible? And would it, therefore, not be more appropriate for anyone interested in regional integration to see that the institutional-driven tendencies and the natural-driven tendencies go in the same direction? These and other questions prompted Jaime Ros to give an immediate clarification.

Jaime Ros: "I realise that I made too much of the contrast between institutional – I mean, driven by agreements – and natural processes. What I want to correct is the impression that I may have given that these two processes are completely separate. This is not the case. I mean, NAFTA is after all an agreement between the US, Canada and Mexico, which are three natural partners. And Mercosur is an agreement between four countries which are natural partners. So the institutional processes are not completely divergent. The point I was trying to make, however, is that it will not make much difference for Chile's future trading relationships whether it gets into NAFTA or not. Or, to give you another example, it will not make much difference whether Uruguay gets into NAFTA or not, or whether Argentina gets into NAFTA or not. These are countries that are predestined to become first South American countries in an economic sense, with a high density of trading relationships with their other natural partners in South America. It is only in the long term that they may become hemispheric countries and in that sense part of NAFTA."

Percy Mistry then asked Jaime Ros what would be the right sequencing for Latin American countries. "If you are Chile, what would make more sense for you to do: join NAFTA first, or join Mercosur first, or repair the relationship to the Andean Pact and join that first? What do you do? And what should be the sequence then between the agglomerations eventually becoming hemispheric?"

According to Jaime Ros, the choice of sequence would not be obvious at all. "Let me take the case of Chile. The choice for Chile is not necessarily NAFTA or Mercosur. There are, for instance, serious disadvantages of joining Mercosur. Why? Because Chile has a much more diversified basis of natural partners in the hemisphere than other Mercosur countries. So it may not be in its interests to join a bloc which would protect a sub-set of its

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natural partners. It may well be that it is in the best interests of Chile to try to go for what it has been doing, which is free trade agreements with a large number of natural partners."

Robert Devlin strongly endorsed Bouzas' plea for trying to make regionalism and multilateralism compatible. For this purpose, Article 24 of the World Trade Organisation (WTO) would be a very useful mechanism, Devlin said with a tone of optimism. "In fact this may happen because since so much world trade now is preferential, a lot of the disputes that are going to emerge are going to do so within the context of integration agreements, and this could bring the whole question of regionalism more into the WTO than might be the case when integration was a sort of side player in the world scenario."

Devlin also stressed the importance – and difficulty – of resolving the 'convergence issue'.

"There are a lot of different approaches being put out there and I hardly know how to go about it. There are some who like the market approach: just let the chips fly and sooner or later it will all get together and there will be one big hemisphere. Then there is the sub-regional approach: most Latin American countries are not really ready for hemispheric integration, so play in the little leagues, stay in your sub-regional group, make it stronger and then come back and talk to me when you are up to international standards. Then there is the NAFTA group who think that NAFTA should be the platform from which to proceed with hemispheric integration. And a variant of that is the SAFTA/NAFTA hypothesis.

The US thinks the process should be US-led and NAFTA-based. I myself am sceptical about NAFTA serving that role, basically because the NAFTA partners right now talk about the 'highest standards' – NAFTA is much more than a free trade agreement. They are insisting that the standards be as high as NAFTA and either you play or you don't. Well, I have a feeling that very few countries in Latin America, at this stage anyway, are able to reach those 'highest standards', which means that a lot of people will be left out the game, and this could have some of the detrimental effects Roberto referred to. Then there is also the question of whether NAFTA is the proper vehicle, because in many respects NAFTA is very forward-looking and advanced, but there are aspects that aren't so advanced. A good example is the rules of origin, which are much more restrictive than the LAIA rules of origin. So it is not clear that NAFTA would be what Latin America wants to hook on to.

Now, it is likely that some variants of all these options are going to be at play in the next few years and no single one will probably dominate, but the crucial question is: will they converge? That is where I think a multilateral mechanism is an important thing to push for at the political level because it helps to overcome some of the problems that Roberto was pointing out about the uncertainty of where regional integration is going."

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Cristian Ossa wondered whether one could really infer much from Jaime Ros' classification regarding the niches in which every Latin American country could eventually flow if trade intensity vis-à-vis each other and vis-à-vis the United States were considered. "If one looks, for example, at the bilateralist group, we have Canada, Mexico, Venezuela, Ecuador. All these countries are largely there because of natural resource endowment – all of them are oil exporters. As it happens today, the US is a large oil importer, but 20, 30 years ago the situation could have been quite different. And, in the future, the situation may change again. So shouldn't we look more at the financial interaction amongst firms, and the interaction at different levels between trading partners, rather than just at global figures which may be largely determined by natural resource endowment?"

A second point raised by Ossa was that Roberto Bouzas had mentioned some of the costs of not being in NAFTA – the erosion of preferences, trade diversion – but that perhaps another cost should be added. "Staying out, voluntarily or involuntarily, has perhaps major costs in terms of perception of managing the corresponding economy. About those who are out, it has often been said that they don't fulfil basic macroeconomic conditions, or that they are heavy polluters, or that they are irresponsible. This is not something we can easily measure, but in the perception of financial agents – and also governments or multilateral institutions – it no doubt has a pejorative connotation. So perhaps this is something one should take into consideration when studying the costs of staying out of NAFTA."

Reply by Roberto Bouzas

"I understand Jaime Ros' comments as stating not that procedures or institutions or mechanisms don't matter, but that what the indices tell reinforces certain institutional decisions or certain mechanisms to converge or to make the preferential trade agreements in the Western Hemisphere converge. I think it is not an either/or, but rather the one reinforcing the other. Institutional mechanisms reinforce those agreements which make economic sense, though the definition of what makes 'economic sense' may be a long discussion.

As regards Robert Devlin's observation about the role of Article 24 of WTO, the new understanding and interpretation of Article 24 may become an improvement on the previous Article 24 of GATT. Yet, I think that Article 24 in its new form does not address one crucial issue: accession rules and transparency as regards accession. In that field there is a role and there should be at least a forceful expression on the part of the Latin American policy-makers that this kind of mechanism should be established at the hemispheric level, even if it is not at the multilateral level. Basically because I think that when large disparities of market power exist, rules are important. It is essential that we create more effective rules, at least at the hemispheric level.

There was a question by Percy Mistry about where to go next in terms of policy decisions in Latin America. What do you join first? There is no straight and unique answer to that question. It depends very much on the particular country we are talking about and the cost-benefit analysis – not only the economic cost-benefit analysis, but also the political cost-benefit analysis – which is made. What is sure for most Latin American countries, if not for all, is that most policymakers should work for more transparent mechanisms in the hemisphere.

Finally, about the cost, other than trade and investment cost, of not entering NAFTA, I think we really have to make an effort to take this out of the discussion. The idea that NAFTA was a seal of approval for good macroeconomic management has been very dramatically contested in December 1994 by the Mexican crisis. So I think we would rather take out this 'seal of approval' issue. For instance in the case of Chile, you don't really need two seals of approval. If you did things right and you were able to do that in the context of an open economy and a stable macroeconomic environment, what would you need a new seal of approval for? So I think that after the Mexican events the seal of approval issue has shown itself to be much more relative and politically biased and motivated than was thought a year ago."

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Appendix

List of Participants in the Seminar on Regional Economic Integration and Global Economic Cooperation: The Case of Latin America and the Caribbean, Santiago de Chile, 1-2 March 1995

Mr. Shahen Abrahamian	Officer-in-Charge, Global Interdependence Division, UNCTAD
Mr. Oscar Altimir	Deputy Secretary General, UN Economic Commission for Latin America and the Caribbean (ECLAC)
Mr. Augusto Aninat	President of the Board of Directors, Administración Zona Franca de Iquique S.A. (ZOFRI)
Mr. Héctor Assael	Chief, International Trade, Finance and Transport Division, ECLAC
Mr. Renato Baumann	Economic Affairs Officer, UN Economic Commission for Latin America and the Caribbean (ECLAC), Brazilian Office
Ms. Antonieta del Cid de Bonilla	Vice-President, Banco de Guatemala
Mr. Roberto Bouzas	Senior Research Fellow, Facultad Latinoamericana de Ciencias Sociales (FLACSO)
Mr. Robert Devlin	Chief of Integration, Trade and Hemispheric Issues Division, Inter-American Development Bank
Mr. Mohamed A. El-Erian	Assistant Director, Office of the First Deputy Managing Director, International Monetary Fund
Mr. Juan Guillermo Espinosa	Director CIENES, Organization of American States (OAS)

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Mr. Ricardo Ffrench-Davis	Principal Advisor on Economic Policy, ECLAC
Ms. Fay Housty	Programme Manager, External Economic and Trade Relations, Caribbean Community Secretariat (Caricom)
Mr. Alberto van Klaveren	Senior Advisor, Policy Planning Department, Ministry of Foreign Affairs, Director, Institute of International Sudies, University of Chile
Mr. Manuel Marfan	Deputy Minister of Finance, Chile
Mr. Percy S. Mistry	Chairman, Oxford International Group
Mr. Cristian Ossa	Director, Department of Economic and Social Information and Policy Analysis, United Nations Headquarters
Mr. Peter Robinson	Zimconsult, Harare
Mr. Jaime Ros	Helen Kellog Institute for International Studies, University of Notre Dame
Mr. Raúl E. Sáez	Center of Economic Research on Latin America (CIEPLAN)
Ms. Claudia Schatan	Economic Affairs Officer, Economic Development Unit, ECLAC, Mexico-Office
Ms. Barbara Stallings	Director, Economic Development Division, ECLAC
Mr. Osvaldo Sunkel	UN Economic Commission for Latin America and the Caribbean (ECLAC)
Mr. Jan Joost Teunissen	Director, Forum on Debt and Development

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