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.

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

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,

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

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.

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

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.

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

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.

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

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).

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

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

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.

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

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.

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

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

---

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).

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

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).

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

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]

---

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.

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

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

---

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).

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.

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

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.

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).

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

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.

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

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.

---

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.

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

References

Balassa, B. (1961), *The Theory of Economic Integration*, Homewood: Ill., Irwin, 1961.

Bliss, C. and J. Braga de Macedo (eds.) (1992), *Unity within Diversity in the European Economy: The Community's Southern Frontier*, Cambridge: Cambridge University Press, 1992.

Bouzas, R. (1995), "Mercosur and Preferential Trade Liberalisation in South America: Record, Issues and Prospects", In: *Documentos e Informes de Investigación*, Núm. 176, January, 1995.

Bouzas, R. and J. Ros (1994), "The North South Variety of Economic Integration", In: R. Bouzas and J. Ros (eds.), *Economic Integration in the Western Hemisphere*, Notre Dame: Ill., University of Notre Dame Press, 1994.

Bouzas, R. and R. Ffrench-Davis (1995), "International Actors and Linkages in Latin America", In: *Documentos e Informes de Investigación*, Núm. 174, January, 1995.

da Motta Veiga, Pedro (1995), "Liberalização Preferencial entre Brasil e EUA: Condicionantes e Estrutura de Incentivos", In: *Revista Brasileira de Comercio Exterior*, Num. 42, janeiro/março, 1995.

de Melo, J., A. Panagariya and D. Rodrik (1992), "Regional Integration: An Analytical and Empirical Overview", Paper prepared for presentation at the World Bank Conference "New Dimensions in Regional Integration", mimeo, Washington DC, 1992.

Dornbusch, R. and A. Werner (1994), "Mexico: Stabilisation, Reform and No Growth", In: *Brookings Papers on Economic Activity*, Vol. 1, 1994.

El-Agraa, Ali M. (1989), *The Theory and Measurement of International Economic Integration*, New York, NY: St Martin's Press, 1989.

Erzan, R. and A. Yeats (1992), "US-Latin American Free Trade Areas: Some Empirical Evidence", In: S. Saborio and contributors, *The Promise and the Premise: Free Trade in the Americas*, New Brunswick, NJ: Transaction Books, 1992.

Hufbauer, G.C. and J. Schott (1994), *Western Hemisphere Economic Integration*, Institute for International Economics, Washington DC, 1994.

Khaler, M. (1993), "Regimen comercial y diversidad nacional", In: *AMERICA LATINA/Internacional*, vol. 1 núm. 1, primavera, 1993.

Krugman, P. (1992), "Macroeconomic Adjustment and Entry into the EEC", In: C. Bliss and J. Braga de Macedo (eds.), *Unity within Diversity in the European Economy: The Community's Southern Frontier*, Cambridge: Cambridge University Press, 1992.

Krugman, P. and A.J. Venables (1992), "Integration and Competition of Peripheral Industry", In: C. Bliss and J. Braga de Macedo (eds.), op. cit.

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

Lawrence, R., A. Bressand and T. Ito (1995), *A vision for the World Economy*, The Brookings Institution, Washington DC, 1995.

Lipsey (1993), "Getting There: The Path to a Western Hemisphere Free Trade Area and Its Structure", in S. Saborio and contributors, op. cit.

Lustig, N. (1994), "NAFTA: Potential Impact on Mexico's Economy and Beyond", In: R. Bouzas and J. Ros, op. cit.

Martin, M., W.A. Messina Jr and T. Taylor (1994), "Implications of the NAFTA for Central American Development", mimeo, 1994.

Primo Braga, C.A. (1992), "NAFTA and the Rest of the World", in N. Lustig, B.P. Bosworth and R.Z. Lawrence, *Assessing the Impact of North American Free Trade*, Brookings Institution, Washington DC, 1992.

Ros, J. (1993), "¿Zona de libre comercio o mercado común de capitales? Notas sobre la apertura mexicana y la integración económica con Estados Unidos", In: R. Bouzas et al., *Los procesos de integración en América Latina*, CEDEAL, Madrid, 1993.

Ros, J. (1994), "Mercados Financieros y Flujos de Capital en México", In: J.A. Ocampo (ed.), *Los Capitales Extranjeros en las Economías Latinoamericanas*, FEDESARROLLO/Banco Interamericano de Desarrollo, Bogotá, 1994.

Saborio, S. and contributors, *The Promise and the Premise: Free Trade in the Americas*, New Brunswick, NJ: Transaction Books, 1992.

USTR (1995), "US Proposal for Agreement at Denver Trade Ministerial Summit", In: *Inside NAFTA*, May 3, 1995.

Wonnacot, R.J. (1991), *The Economics of Overlapping Free Trade Areas and the Mexican Challenge*, C.D. Howe Institution, Toronto, 1991.

World Trade Organisation (1995), "Regionalism and the World Trading System", Geneva, April, 1995.

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