The FTAA: Some Longer Term Issues

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THE FTAA:

SOME LONGER TERM ISSUES [*]

Robert Devlin, Antoni Estevadeordal
and Luis Jorge Garay[**]

{PRIVATE }I. INTRODUCTION {tc \l 1 "I. INTRODUCTION"}

The Free Trade Area of the Americas (FTAA) process was launched during the Miami Summit of Heads of State in December 1994. It was the centerpiece of a broader hemispheric initiative of political and socio-economic cooperation among 34 countries of the Americas with the objective to negotiate a hemispheric free trade agreement by the year 2005. The preparatory phase began in January 1995 and formal negotiations were launched in April 1998. The creation of an FTAA would clearly be the most important chapter in the history of regional cooperation in the Western Hemisphere and mark a fitting culmination to a fast maturing trade policy framework in Latin America and the Caribbean.

The FTAA process is the result of progressive globalization of the world economy and a profound transformation in the region based on: (i) structural economic reforms in almost all the countries directed at stimulating market activity and a better articulation with the world economy; (ii) the emergence, or strengthening, of democratic regimes almost everywhere and (iii) political commitments to foster peace and cooperation among neighbors with a history of rivalry and conflict. Regional integration has been a fundamental complementary tool for achieving these ambitious national objectives, which permeate the entire region. Latin America and the Caribbean have a long tradition of interest in regional integration. An intense amount of activity in this area emerged out of the Post-War period. However, the initiatives in the first three decades following the War inserted themselves in the prevailing state-led import substitution strategy of the time, itself to a large extent a product of “market skepticism” derived from the Great Depression. In the 1990s, however, a “new” regionalism emerged in Latin America and the Caribbean that conformed to the new national strategies for economic and political transformation and preparation for globalization.

Trade liberalization has been a centerpiece in the structural reform process. It has opened Latin American and Caribbean markets to unprecedented competition from the rest of the world, providing access to new and better consumer goods, and cheaper inputs and technology for production, investment and enhanced international competitiveness. The extent of the liberalization efforts in the last decade has varied from country to country, but overall trade in the region is more open today than it has been since the period before the 1930s. Although the credit for trade liberalization should go primarily to the unilateral policies of countries, which became

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widespread in the late 1980s and early 1990s, the GATT Uruguay Round negotiations and a wave of regional trade agreements have played, and continue to play, a crucial role. As will be argued later, regional integration has allowed countries to push forward in terms of trade liberalization further than they perhaps could achieve in either the unilateral or multilateral agenda and thereby maintain the momentum of trade reform. But since the objectives and practice of the new integration tend to go beyond the traditional limited focus on liberalized (often very partial) goods trade, to include an array of new market-based trade and trade-related disciplines, the regional agreements often constitute a positive political economy externality which serves to anchor even more the broader overall national reform process. In addition, there are the political externalities: countries have used regional integration to mutually cement their new democratic systems and to create interdependencies which reduce interest in pursuing historical rivalries and promote regional cooperation in areas other than trade.

For awhile many doubted the seriousness of the FTAA initiative. But the launching of negotiations in April 1998, coupled with clear signs of gathering momentum, the FTAA now is clearly a regional process closer to becoming a reality. It thus is worthwhile to review, if only in a limited way, some economic policy and strategic issues that will condition the effects of the FTAA on its member countries.

Our chapter will begin with an overview of the context for the emerging new regionalism and the FTAA. This will be followed by a generic checklist of some of the potential benefits and costs that might be anticipated from an FTAA as well as another checklist of collective and national policy issues that could help to maximize the potential for favorable effects and minimize the costs. The last chapter will preliminarily develop one particular aspect of the FTAA, which will be an important determining factor of the balance of costs and benefits: the way in which the FTAA articulates with existing regional arrangements in the hemisphere. We close with some brief conclusions.

Finally it is important to point out that for the purpose of analysis, the paper assumes that countries have assessed their alternatives and consequently are actively participating in the FTAA because they effectively share the objective of the Miami Summit, which the hemisphere's trade ministers have repeatedly reconfirmed in Denver, Cartagena, Belo Horizonte and San Jose. It also assumes that the FTAA will effectively emerge on or around 2005. Meanwhile, the chapter's scope does not permit an analysis of the world financial crisis, even though it is quite obvious that the FTAA, world trade and indeed any meaningful economic initiative, is threatened by systemic instability in international financial markets.[1]

[1] The Brazilian crisis and devaluation occurred at the time of finalizing the paper for editorial submission. Hence its repercussions are not dealt with here. However, once the Brazilian and MERCOSUR situation stabilizes the end result should be positive for the FTAA: Brazil's greater price competitiveness will signal new market opportunities in the hemisphere. For a preliminary analysis of the effect of the Brazilian crisis on Latin American integration and the effects of the Asian crisis on the region's international trade prospect see IDB *Periodic Note* [1998].

{PRIVATE }II. THE NEW REGIONALISM IN THE AMERICAS{TC \L 1 "II. THE FTAA AND THE NEW REGIONALISM IN THE AMERICAS"}

The FTAA effort is a good example of the new regionalism. Based on its ambitious formal agenda the FTAA initiative seems to fit well into the particular stylized facts of a type of regional integration which Ethier (1998) has recently argued is welfare enhancing: (i) the integration agreement typically involves small countries linking up with large countries (ii) the smaller countries have made, or are making, significant unilateral reforms (iii) the degree of liberalization in the agreement is typically modest (iv) the liberalization achieved is primarily by the smaller countries (v) the agreements often involve "deep", or comprehensive, objectives (vi) the agreements are regional in a geographical sense. While not circumscribing ourselves to Ethier's framework, we share his basic point that it is a mistake to evaluate the prospects of the new regionalism -in this case the FTAA- on narrow Vinerian criterion because much more is at play (Ethier [1998] pp. 1149-61).

To effectively evaluate its roots, dynamics and its long run implications, one must understand the context in which the FTAA process was initiated. Since the late 1980s there has been a growing interest in regional approaches to trade liberalization. One of the earliest manifestations appeared in the Southern Cone with new sectoral and regional cooperation agreements that marked the incipient development of what we know today as MERCOSUR.[2] It also manifested itself among some developed countries, in particular, the United States' move to bilateral trade negotiations and the deepening of the European internal market. During the same period most of the developing world was moving toward substantial market-oriented economic reforms, including unilateral trade initiatives. In addition, all of this was happening in the context of multilateral efforts in Geneva to liberalize trade in goods and services around the world, which culminated in the Uruguay Round Agreements in 1994 and the creation of the World Trade Organization in 1995.

By mid-1990s, the regional approaches to trade liberalization had spread throughout the world: in Europe, in Asia and in the Americas. The rest of this chapter is a detailed chronology of these events in Latin America and the Caribbean. It will illustrate how the new regionalism has made its mark in the way trade relations are conducted in the region. If one had to select a single benchmark period in recent times that best captures the features of this new regionalism in Latin America and the Caribbean, it would be around the time of launching of the FTAA at the Miami Summit.

The mid-1990s marks the tenth anniversary of the beginning of the wave of substantive unilateral trade reforms undertaken by the countries of the region (IDB [1996a]). The depth of these reforms is evident when evaluating a number of basic criteria. Average tariffs fell from 40 to 11 percent and for most countries those tariff cuts were of the order of 50 percent and they were implemented over relatively short periods of time (i.e., two to three years). Average maximum tariffs in the region fell from more than 80 percent to 40 percent with only two countries presently applying maximum tariffs of up to 100 percent on a small number of products. Tariff dispersion, on average, has declined from 30 percent in the mid-1980s to 9 percent today. Both the highest average rate and the highest dispersion rate, as measured by the standard deviation, are currently under 15 percent.

[2] For more details see INTAL [1996].

There are still, however, some important peak tariffs, particularly in the Caribbean Community. On average, approximately 22 percent of tariff lines are subject to rates above 20 percent. Moreover, there are still some countries with maximum tariffs above 70 percent.

TABLE 1

TARIFF STRUCTURE IN LATIN AMERICA, 1985 – 1997

		1985	1988	1991	1994	1997
Average Tariff Rates (Unweighted Averages)	Argentina	39.3	30.8	14.2	15.4	14.1
	Bolivia	22.7	16.6	9.2	9.7	9.6
	Brazil	55.1	41.5	20.4	9.7	14.9
	Chile	20.2	15.1	10.8	10.9	10.8
	Colombia	46.5	46.3	16.4	11.3	11.4
	Ecuador	58.7	44.5	16.6	11.0	9.9
	Mexico	33.6	10.2	12.6	12.4	13.7
	Paraguay	18.7	18.6	13.6	7.3	10.0
	Peru	64.4	70.5	16.2	15.6	13.1
	Uruguay	35.9	26.9	21.3	13.6	10.1
	Venezuela	31.6	42.2	15.1	11.3	11.5
Tariff Dispersion (Standard Deviation)	Argentina	9.4	10.3	6.0	8.8	6.4
	Bolivia	4.6	1.3	2.5	1.1	1.4
	Brazil	28.0	19.5	16.8	6.9	7.1
	Chile	1.6	.9	1.5	.9	1.2
	Colombia	16.9	17.4	8.0	5.8	5.8
	Ecuador	56.0	35.0	10.4	6.0	8.3
	Mexico	20.3	6.6	5.2	5.5	14.2
	Paraguay	13.8	13.7	11.8	6.8	6.3
	Peru	24.6	24.4	5.8	3.8	3.6
	Uruguay	14.9	11.3	6.5	5.9	6.4
	Venezuela	25.2	36.3	11.0	6.1	5.8
Tariff Peaks (Average tariff rates top 1 Percent products with highest tariffs)	Argentina	51.5	57.6	25.0	30.0	27.2
	Bolivia	32.3	17.0	10.0	10.0	10.0
	Brazil	108.0	85.0	70.0	20.0	35.0
	Chile	27.4	20.0	11.0	11.0	11.0
	Colombia	85.0	88.0	51.4	20.0	20.0
	Ecuador	245.0	125.0	37.0	20.0	24.5
	Mexico	105.5	20.0	20.0	20.0	56.2
	Paraguay	50.0	50.0	52.0	32.0	23.7
	Peru	104.0	109.0	25.0	25.0	25.0
	Uruguay	60.0	45.0	30.0	20.0	22.0
	Venezuela	100.0	139.9	40.0	20.0	20.0

Source: A. Estevadeordal [forthcoming].

In April 1994, the Uruguay Round Final Act was signed at Marrakesh, ending almost a decade of multilateral trade negotiations. The agreements which made up the final package entered into force in January 1995, including the agreement establishing the World Trade Organization which is responsible for administering the most sophisticated and comprehensive world trade agreement ever signed. In the area of tariff liberalization, this latest round of GATT negotiations achieved an average tariff reduction of 38 percent in industrialized countries and, from the standpoint of the Latin American and the Caribbean countries, implied substantial commitments to dismantle import barriers. The central obligation with respect to tariffs requires countries to limit their levels to a specified maximum or so-called GATT tariff commitment or “binding”. The latest round resulted in a significant increase in the number of bound tariff lines. In the case of developed countries, the increase went from 22 to 72 percent; and in the case of countries in transition, it went from 78 to 98 percent. Latin America as a whole agreed to bind practically all tariff lines. This is especially significant when compared to the tariff bindings existing before the Uruguay Round began. In Latin America as a whole, only 38 percent of tariff lines for industrial products were bound, equivalent to 57 percent of imports. For agricultural products, the percentages were 36 and 74 percent, respectively.

The same year the multilateral talks ended (1994), there were dramatic advances in the new regionalism, with the Western Hemisphere being a major staging ground. Months before the signature of the Final Act of the Uruguay Round, the North American Free Trade Agreement (NAFTA) was implemented. In addition, important advances were made in the Southern Cone in preparation for the launching of MERCOSUR in January 1995. Moreover, during the same time period two countries in the hemisphere were in the process of consolidating their positions as strategic trade hubs in the region. Mexico was able to secure in 1994 three important agreements which were based on the “NAFTA” model with Costa Rica in April, with Colombia and Venezuela (known as the G-3 Agreement), in June and with Bolivia in September. All three agreements were implemented at the beginning of 1995. For Chile, 1994 marked an acceleration in a series of bilateral agreements in the hemisphere (Mexico, 1991; Venezuela, 1992; Colombia, 1993; and Ecuador, 1994). During the same year, Chile initiated free trade talks with MERCOSUR countries and Canada and began a second round of negotiations to deepen its agreement with Mexico. These strategic agreements would be signed in subsequent years (1996,1997 and 1998, respectively). In addition, around the same time, important institutional and policy reforms were carried out in existing agreements such as the Andean Pact (to become Andean Community in 1997), CARICOM and the Central American Common Market.

This dynamism was also present at the extraregional level, in particular, in the context of the APEC initiative. Mexico joined APEC as a full member in November 1993 and Chile entered one year later. Moreover, during the II Presidential Meeting of APEC in November 1994 in Indonesia, the leaders agreed to achieve the goal of free trade and investment in the region no later than 2010 for the industrialized economies and 2020 for developing countries.

This brief history of the integration efforts in the mid-1990s would be incomplete without reference to the European Union. The EU involvement with Latin America was also renewed in December 1995 with the signature of a trade and economic cooperation agreement with MERCOSUR. This was followed by a Framework Cooperation Agreement with Chile in June 1996 and talks with Mexico toward a new trade and economic agreement in the years to come.

TABLE 2

REGIONAL TRADE AGREEMENTS IN THE AMERICAS IN THE 1990's

Agreement	Date of Signature	Entry Into Force
Caribbean Community (CARICOM)[1]	1989	1990
Chile-Mexico[2]	1991	1992
Central American Common Market (CACM)[3]	1990	1993
CARICOM-Venezuela	1992	1993
Chile- Venezuela	1993	1993
North American Free Trade Agreement (NAFTA)	1992	1994
Boliva-Chile[4]	1993	1993
Colombia-Chile	1993	1994
Southern Cone Common Market (MERCOSUR)	1991	1995
Costa Rica-Mexico	1994	1995
Group of Three (G-3)	1994	1995
CARICOM-Colombia	1994	1995
Bolivia-Mexico	1994	1995
Chile-Ecuador	1994	1995
Andean Community[6]	1988	1996
Chile-MERCOSUR	1996	1996
Canada-Chile	1996	1997
Bolivia-MERCOSUR	1996	1997
Mexico-Nicaragua	1997	1998
CACM-Dominican Republic[7]	1998	1999
CARICOM-Dominican Republic[8]	1998	1999

SELECTED AGREEMENTS UNDER DISCUSSION

Regional

Free Trade Area of the Americas (FTAA); Andean Community-Brazil; Andean Community-Panama; CACM-Chile; CACM-Panama; Chile-Panama; Costa Rica-Trinidad & Tobago; Mexico-Belize; Mexico-Ecuador; Mexico-Northern Triangle (El Salvador, Guatemala, Honduras); Mexico-Panama; Mexico-Peru; Mexico-Trinidad & Tobago; Mexico-Uruguay.

Extra-Regional

MERCOSUR-European Union; Mexico-European Union; Chile-European Union; Chile-South Korea; Mexico-Japan; CARICOM-European Union (Lomé Convention renewal); APEC.

Notes:
1. CARICOM began its reform process in 1989 (Declaration of Grand Anse) and agreed to launch a harmonized CET in 1990.
2. The two countries substantially revised and upgraded this accord in an agreement that was signed and entered into force in 1998.
3. The Presidents agreed to re-activate the CACM in 1990 (Montelimar Summit) and opted to definitively pursue a customs union in 1993 (Protocol of Guatemala).
4. Negotiations are currently underway to revise and upgrade the agreement
5. In 1988, the Presidents agreed (in the Protocol of Quito) to amend the founding Charter of the Andean Group and alter the existing tariff reduction program. In 1996, the leaders officially agreed to change the Group's name to the Andean Community and reform certain existing institutional structures (Declaration of Trujillo).

6. The Agreement has yet to receive legislative approval in all countries and is only in effect in those countries that have ratified it.
7. The Agreement is expected to enter into force this year.

The summary account is relevant not only for chronological purposes, but also for stressing some of the specific facts that have characterized most of the new regionalism in Latin America, as well as, the synergies and complementarities that exist among the different approaches to trade liberalization. First, a key factor in explaining the commitments undertaken by the Latin American and Caribbean countries during the Uruguay Round negotiations were the successful policy reforms -in which unilateral trade liberalization is central- carried out at the national level. In turn, the countries' agreements at the multilateral level acted as a signal to investors of their commitment to external opening and contributed as a lock-in mechanism for the domestic reforms. At the same time, the Uruguay Round agreements set the stage for the pursuit of regional agreements under a common umbrella of global trade rules, as well as, imposed a clearer set of disciplines under which preferential agreements can be negotiated.[3]

Second, while the reciprocal nature of the multilateral round provides a national political underpinning to further liberalization, and the economic advantages of free trade achieved at the multilateral level are well understood, it is sometimes difficult to evaluate negotiating opportunities in the context of the traditional framework of request/offers, which take place in a forum of more than one hundred countries with very different strategic interests (Estevadeordal and Robert [forthcoming]). This can delimit the depth of new commitments. Moreover, Latin American and Caribbean countries' control over the initiation, agenda and pace of a multilateral round is limited.

Regional and bilateral agreements offer certain advantages in this respect. These agreements also offer reciprocity. However, they usually involve a smaller group of geographically defined countries with a very clear profile of shared interests in commercial trade, geopolitics and regional cooperation. This can provide a better environment for reaching consensus on the complex range of issues in modern trade agendas; for measuring the potential gains from committing scarce resources to a protracted negotiation involving reciprocity and for private sector understanding and support of the liberalization process. Ethier finds that the incentives for exploiting the advantages of regional negotiations are higher the more successful are multilateral rounds (Ethier [1998]).

In effect, the wave of new regional trade agreements, the deepening of those already in existence, and the launching of FTAA negotiations at a hemispheric level should be seen, first, as a complement to the unilateral reforms and multilateral negotiations. Second, and most importantly, they are laboratories for the development of new paradigms for the design and implementation of trade policy around the world.

From an analytical point of view, traditional economic analysis has distinguished between different stages of economic integration. In this literature, liberalization under a free trade agreement, as proposed under the FTAA initiative, would constitute a relatively less advanced stage of integration than a common market scheme since it involves preferential trade liberalization among partners, but not the adoption of common protection policies towards third countries and free movement of factors of production. This type of analysis had some validity in

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[3] This is manifest in the new Understanding on the Interpretation of Article XXIV of the GATT 1994.

a world of relatively closed economies where trade policy is mostly concerned with the management of border measures (i.e., tariffs and non-tariffs measures). However, in an increasingly globalized world economy, trade flows are affected not only by border type measures but by domestic policies as well. This shift to the so-called “deeper” integration emerged first at the national level where unilateral trade reforms have been accompanied by substantial macroeconomic, financial and regulatory reforms. The shift has also been very clear in recent multilateral negotiations where a new set of issues has emerged on the trade agenda. These include trade in services, intellectual property, trade related investment measures and dispute settlement mechanisms. A contentious agenda lies ahead in other areas of possible harmonization efforts such as competition policy and environmental standards. This increased coverage of areas for the harmonization and reconciliation of domestic policies is also increasingly present in the new regional integration agreements.

Based on these criteria, within the region, a distinction should be made between two existing types of free trade agreements. First, there are traditional or “first generation” agreements mostly negotiated in the framework of the Latin American Integration Association (LAIA, or ALADI in Spanish). These primarily focus on traditional market access issues under very simple normative frameworks. They are rightly called preferential agreements and can be subject to a traditional “Vinerian” analysis. These agreements in turn can be divided between “selective-and-partial” and “universal-and-automatic” preferential agreements according to the product coverage and the mechanisms used for implementing the preferential treatment for market access purposes. Second, there are the “new generation” of agreements characterized by their coverage of issues in the new global trade agenda, such as services, investment, government procurement and competition policy. Moreover, in these agreements traditional market access liberalization is characterized by its broad coverage and implemented through automatic phase-out programs. Indeed, the regional integration agreements in Latin America have involved automatic schedules of elimination of tariffs on substantially all trade, with the bulk of liberalization taking place in 10 years and exceptions rarely exceeding 6% of all tariff lines (A. Estevadeordal [forthcoming]).

While one must await the outcome of negotiations, the terms of reference for discussions now underway in the FTAA are suggestive of an agreement containing at least most of the elements of the new regionalism.

{PRIVATE }III. EVALUATING THE FTAA IN A LONG TERM PERSPECTIVE{TC \L 1 "III. PREPARING FOR THE FTAA\: SOME LONGER TERM ISSUES"}

Regional integration is an initiative with a long run horizon. Many of the most important effects of successful regional integration schemes involve complex interrelationships that develop in a general equilibrium framework over a long period of time (Devlin and Ffrench Davis [1999]) Typically at the beginning, and each time the agreement formally deepens its commitments, there are significant costs to be assumed up front with benefits playing out over a much more extended timeline.

Many economists focus their primary attention on whether regional integration induces what Viner (1950) first termed trade creation or trade diversion (Viner [1950]). From a standard static Vinerian economic model of integration it is well known that to increase the chances of trade creation there should be an important overlap among potential members in sectors protected by high tariffs, as well as wide differences between member countries in the costs of producing the goods in the protected industries. To minimize the potential for trade diversion, there should be, first, a large number of potential members, so that there are few countries whose trade could be diverted; second, initially a low level of trade relative to production; and third, a significant proportion of pre-agreement trade conducted with future partners. In short, the agreement is going to be less likely trade diverting if formed among countries whose economies are currently competitive, but potentially complementary. Yet these “static” Vinerian effects of a regional integration agreement are only a small part of a successful story.

Dynamic effects are potentially much more important since they are associated with linked to an increase in competitive pressures following the removal of trade barriers. In effect, regional integration is about the “dynamic” economic transformations brought about by intensified competition; reduction of economic rents; exploitation of economies of scale, scope and agglomeration; marketing and export experience; managerial efficiency, and so on. Today’s integration also aims at so called non-traditional gains such signaling commitments to investors, lock-in of policy reform, strengthening institutions and rules-based procedures, political economy synergies among partners and geopolitical objectives (Fernandez [1997]). These effects could raise risk- adjusted rates of return and induce investment local and foreign, technological change and growth. Indeed, even what may first appear as a cost through trade diversion could in the right circumstances be a platform for an economic transformation with benefits for the subregion and the world economy as a whole. Unfortunately, economists have found the analysis of these latter dynamic effects of regional integration difficult to model and test empirically (Baldwin and Venables [1997]). Indeed, strong conclusions about regional integration initiatives are all too often drawn exclusively on static analysis, which aside from providing a very incomplete story, also has its own methodological shortcomings.[4]

When national economies integrate there is an important reallocation of resources within and between those economies. When the integrating economies are relatively homogeneous, involved

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[4] See for example the analysis of Yeats ([1998] pp. 1-28) concerning MERCOSUR. For a concise critique of Yeats, which first appeared in 1996, see Devlin [1996].

in significant trade with each other and converging in terms of income levels and technological development, the forces of integration could be heavily represented by growing intra-industry trade. In this context, adjustments can be expected to be relatively fast and with moderate economic disruptions.[5] When integration is among very heterogeneous countries in terms of income and technological development, trading relationships are still underdeveloped and they share an overlapping product mix, the process of regional integration initially may be more heavily represented by development of inter-industry trade with more significant lags and displacements during the adjustment process.

The FTAA is clearly an integration scheme involving a heterogeneous mix of countries ranging from the world's richest and most competitive countries to some of the poorest and more economically backward. The heterogeneous nature of the FTAA means that, all being equal, both the costs and benefits of integration could be relatively magnified and their distribution uneven among and within countries. Outlined below are some collective and national policy initiatives which could help Latin America and the Caribbean maximize the benefits of an FTAA and help dampen its costs. But first a generic check list is presented on some of the longer term potential benefits and costs, based on the prevailing situation in the hemisphere, which Latin America and the Caribbean could possibly anticipate from a new generation FTAA agreement.

Some Potential Positives{tc \l 2 "A. Some Potential Positives"}

{PRIVATE }Free Access to a Hemispheric Market{tc \l 3 "Free Access to a Hemispheric Market"}

During the 1990s growth of exports to partners within sub-regional integration schemes has generally outperformed other markets (see Table 3). One of the major potential benefits of an FTAA is a more secure and preferential access to that part of the hemispheric market that is outside of the respective formal sub-regional integration schemes. This "extra sub-regional hemispheric market" is quite important for almost all the countries of the region (see Tables 4 and 5) and some models suggest that there would be conditions for considerable creation of trade if an FTAA were to emerge (Hinojosa, Robinson and Lewis [1995]).

Within this hemispheric market, the U.S. is preponderant. Moreover, for countries in the Caribbean Basin the U.S. market weighs heavily not only in the hemisphere but also in total world trade (see Table 6). South of the Caribbean Basin exports to the United States are generally significant, but their share in total trade is a more modest one-third or less. The U.S. market is significant in another important way for many countries: its share as a market for more knowledge-intensive manufactured exports is second only to most countries' sub-regional market. Hence the US market, along with sub-regional integration, has been contributing to Latin

[5] The original membership of the European Union approximated these conditions.

America and Caribbean's long sought after goal of diversifying away from commodity exports to manufactured goods.[6]

[6] For an analysis of the region's export performance, including diversification and potential effects of the Asian crisis, see IDB *Periodic Note* [1998].

TABLE 3
WESTERN HEMISPHERE: TOTAL AND INTRAREGIONAL EXPORTS
(millions US$ and percentages)

		1990	1991	1992	1993	1994	1995	1996	1997	1998(e)	Average 1990-1998
Western Hemisphere [i]	Global Exports	658,234	684,995	727,241	765,511	859,185	996,045	1,065,343	1,157,573	1,144,532	
	% growth	7.9	4.1	6.2	5.3	12.2	15.9	7	8.7	-1.1	7.2
	Extra-hemispheric Exp	341,515	357,391	364,017	365,905	394,303	472,187	490,588	514,397	476,479	
	% growth	5.4	4.6	1.9	0.5	7.8	19.8	3.9	4.9	-7.4	4.3
	Intra-hemispheric Exp	316,719	327,605	363,224	399,606	464,881	523,858	574,755	643,176	668,054	
	% growth	10.7	3.4	10.9	10	16.3	12.7	9.7	11.9	3.9	9.8
	Intra/Total	48.1	47.8	49.9	52.2	34.1	52.6	53.9	55.6	58.4	
Latin America [ii]	Global Exports	137,781	136,242	145,504	155,644	181,573	218,989	240,879	268,548	266,068	
	% growth	10.5	- 1.1	6.8	7	16.7	20.6	10	11.5	-0.9	8.6
	Extra-LA Exports	121,412	116,249	120,662	126,011	146,574	177,194	197,204	215,457	211,949	
	% growth	10.9	- 4.3	3.8	4.4	16.3	20.9	11.3	9.3	-1.6	7.2
	Intra-LA Exports	16,369	19,993	24,943	29,633	34,998	41,793	43,675	53,090	54,119	
	% growth	7.3	22.1	24.3	19.3	18.1	19.4	4.5	21.6	1.9	16.1
	Intra/Total	11.9	14.7	11.1	19	19.3	19.1	18.1	19.8	20.3	
Andean Community	Global Exports	31,605	28,630	28,390	29,654	34,256	38,843	45,480	47,656	38,787	
	% growth	26.1	- 9.4	-0.9	4.5	13.5	13.4	17.1	4.8	-18.6	2.6
	Extra-Andean Exports	30,310	26,912	26,224	26,858	30,952	34,268	40,817	42,029	33,233	
	% growth	26.2	- 11.2	- 2.6	2.4	14.9	11.1	19.1	3.0	-20.9	1.2
	Intra-Andean Exports	1,295	1,719	2,156	2,796	3,404	4,575	4,663	5,627	5,554	
	% growth	23.5	32.7	25.4	29.7	21.7	34.4	1.9	20.7	-1.3	20.0
	Intra/Total	4.1	6	7.6	9.4	9.9	11.8	10.3	11.8	14.3	
CARICOM	Global Exports	4,762	4,771	4,875	4,837	5,933	6,211	-	-	-	
	% growth	6.3	0.2	2.2	- 0.8	22.7	4.7	-	-	-	
	Extra-CARICOM Exports	4,224	4,308	4,408	4,286	5,346	5,407	-	-	-	
	% growth	4.9	2	2.3	- 2.8	24.7	1.1	-	-	-	
	Intra-CARICOM Exports	555	463	467	551	587	815	-	-	-	
	% growth	23.3	- 13.9	0.8	19.1	6.5	38.9	-	-	-	
	Intra/Total	11.7	9.7	9.6	11.4	9.9	13.1	-	-	-	

[i] Western Hemisphere includes Latin america (see following definition), United States and Canada

[ii] Latin America here is Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, and Venezuela.

TABLE 3 (continued from the previous page)

		1990	1991	1992	1993	1994	1995	1996	1997	1998(e)	Average 1990-1998
CACM	Global Exports	4,058	4,138	4,697	5,065	5,509	6,864	9,018	9,597	10,573	
	% growth	12.7	2	13.5	7.9	9.9	24.6	31.4	6.4	10.2	12.7
	Extra-CACM Exports	3,402	3,356	3,697	3,961	4,290	5,408	7,442	7,730	8,500	
	% growth	12.4	-1.3	10.1	7.1	8.1	26.4	37.6	3.9	10.0	12.1
	Intra-CACM Exports	656	782	1,000	1,105	1,229	1,456	1,576	1,866	2,073	
	% growth	14.6	19.1	27.9	10.4	11.3	18.4	8.2	18.4	11.1	15.5
	Intra/Total	16.2	18.9	21.3	21.8	22.3	21.2	17.5	19.4	19.6	
MERCOSUR	Global Exports	46,425	45,911	50,561	54,162	62,112	70,401	74,997	83,210	82,931	
	% growth	-0.3	-1.1	10.1	7.1	14.7	13.3	6.5	11.0	-0.3	7.5
	Extra-MERCOSUR Exports	42,302	40,808	43,341	44,132	50,157	56,018	57,959	62,560	61,537	
	% growth	-1.2	-3.5	6.2	1.9	13.7	11.7	3.5	7.9	-1.6	4.8
	Intra-MERCOSUR Exports	4,123	5,102	7,220	10,031	11,955	14,394	17,038	20,650	21,394	
	% growth	10.8	23.8	41.5	38.9	19.2	20.3	18.4	21.2	3.6	22.9
	Intra/Total	8.9	11.1	14.3	18.5	19.2	20.4	22.7	24.8	25.8	
Group of Three	Global Exports	65,162	65,117	67,451	74,367	86,020	107,625	128,914	144,807	146,333	
	% growth	22.2	0.9	36.1	10.3	17.1	23.8	19.8	12.3	1.1	10.6
	Extra-G-3 Exports	64,127	63,937	65,675	72,023	83,456	104,319	125,749	140,786	142,102	
	% growth	15.5	-0.3	2.7	9.7	15.9	25	20.5	12.0	0.9	10.5
	Intra-G-3 Exports	1,035	1,180	1,776	2,344	2,565	3,306	3,165	4,021	4,231	
	% growth	47	14	50.4	32	9.4	29.9	-4.3	27.0	5.2	19.2
	Intra/Total	1.6	1.8	2.6	3.2	3	3.1	2.5	2.8	2.9	
NAFTA	Global Exports	561,164	591,440	627,933	661,752	738,494	856,598	919,918	999,456	996,926	
	% growth	7.8	5.4	6.2	5.4	11.6	16	7.4	8.6	-0.3	7.4
	Extra-NAFTA Exports	320,667	341,997	354,468	360,444	396,434	461,079	482,396	514,955	486,147	
	% growth	5.2	6.7	3.6	1.7	7.2	19.3	4.6	6.7	-5.6	5.3
	Intra-NAFTA Exports	240,497	249,443	273,465	301,308	352,060	395,520	437,522	484,501	510,779	
	% growth	11.5	3.7	9.6	10.2	16.9	12.3	10.6	10.7	5.4	9.9
	Intra/Total	42.9	42.2	43.6	45.5	47.7	46.2	47.6	48.5	51.2	

Source: IDB, Statistics and Quantitative Analysis of the Integration and Regional Programs Department, based on DATAINTAL.

e = Annual estimates are based on date through November 15, 1998.

TABLE 4

EXPORTS OF LATIN AMERICA BY COUNTRIES AND SUBREGIONS, 1996

(% of total)

	Intrasubregional	Extrasubregional	Total Hemispheric	Rest of the World
Argentina	33.3	23.4	56.7	43.3
Brazil	15.3	29.8	45.1	54.9
Paraguay	63.3	11.1	74.4	25.6
Uruguay	48.0	14.1	62.1	37.9
MERCOSUR	22.7	27.0	49.7	50.3
Bolivia	20.3	46.5	66.8	33.2
Colombia	17.4	52.7	70.1	29.9
Ecuador	8.8	55.8	64.6	35.4
Peru	7.2	32.5	39.7	60.3
Venezuela	7.5	81.0	88.5	11.5
Andean Community	10.3	64.5	74.8	25.2
Costa Rica	12.2	53.9	66.1	33.9
El Salvador	43.8	25.8	69.6	30.4
Guatemala	28.5	51.2	79.6	20.4
Honduras	4.1	63.5	67.6	32.4
Nicaragua	15.3	50.5	65.9	34.1
CACM	20.4	49.9	70.3	29.7
Mexico	0.9	91.9	92.8	7.2
Colombia	8.2	61.8	70.1	29.9
Venezuela	6.0	82.5	88.5	11.5
G-3	2.4	87.7	90.1	9.9
Chile	0.0	36.2	36.2	63.8
Panama	0.0	72.9	72.9	27.1

Source: IDB, Division of Integration, Trade and Hemispheric Issues, based on DATAINTAL.

TABLE 5

IMPORTS OF LATIN AMERICA BY COUNTRIES AND SUBREGIONS, 1996

(% of total)

	Intrasubregional	Extrasubregional	Total Hemispheric	Rest of the World
Argentina	24.5	27.9	52.3	47.7
Brazil	15.5	31.2	46.7	53.3
Paraguay	54.3	14.8	69.2	30.8
Uruguay	44.0	19.9	63.9	36.1
MERCOSUR	20.5	29.2	49.8	50.2
Bolivia	8.6	58.9	67.5	32.5
Colombia	13.0	50.6	63.5	36.5
Ecuador	16.0	51.7	67.7	32.3
Peru	18.4	45.8	64.2	35.8
Venezuela	8.9	64.4	73.3	26.7
Andean Community	13.2	53.6	66.8	33.2
Costa Rica	7.2	71.5	78.6	21.4
El Salvador	19.1	61.7	80.8	19.2
Guatemala	7.7	73.1	80.8	19.2
Honduras	15.4	66.3	81.7	18.3
Nicaragua	24.2	52.9	77.0	23.0
CACM	12.7	67.3	80.0	20.0
Mexico	0.4	79.6	79.9	20.1
Colombia	12.9	50.6	63.5	36.5
Venezuela	11.5	61.8	73.3	26.7
G-3	2.9	74.4	77.3	22.7
Chile	0.0	55.5	55.5	44.5
Panama	0.0	80.1	80.1	19.9

Source: IDB, Division of Integration, Trade and Hemispheric Issues, based on DATAINTAL.

TABLE 6

PERCENTAGE OF LATIN AMERICA'S TRADE WITH THE USA BY COUNTRIES, 1996

	% of Exports to USA	% of Imports from USA
Argentina	8.2	19.9
Brazil	19.2	21.9
Paraguay	3.5	10.8
Uruguay	6.7	12.0
MERCOSUR	15.1	20.6
Bolivia	25.3	27.7
Colombia	38.7	36.0
Ecuador	34.9	31.4
Peru	19.8	26.0
Venezuela	58.8	45.0
Andean Community	45.6	35.3
Costa Rica	41.0	44.8
El Salvador	18.1	39.3
Guatemala	36.6	43.9
Honduras	58.1	50.3
Nicaragua	44.1	33.6
CACM	38.7	43.2
Mexico	84.2	75.5
G-3	76.0	67.9
Chile	15.4	24.4
Panama	51.8	37.3

Source: IDB, Division of Integration, Trade and Hemispheric Issues, based on DATAINTAL.

In terms of market access, for Latin America and the Caribbean the U.S. market, and North America more generally, is clearly a strategic target of the FTAA negotiations. However, trade with the US and Canada is already relatively free due to the low average tariffs in those countries and the fact that the majority of Latin American and Caribbean countries already enjoy duty free access for an extensive range of products on account of an array of non-reciprocal preferential arrangements. Thus the market access benefits of an FTAA will likely focus on three issues. First, negotiating free access for specific products and sectors in North America that face relatively onerous tariffs or non-tariff measures (e.g., agriculture, food products, textiles, and so forth). Second, disciplining, beyond what is available under WTO rules, the use in North America of trade distorting measures and trade remedies (particularly anti-dumping).[7] And third, more generally establishing a predictable rules-based framework through a hemispheric dispute settlement mechanism to ensure enforcement of stable, free access to this market. Without a major advance in these areas the incentive for Latin America and The Caribbean to make concessions on tariff reduction for North American goods as well as in other areas of the negotiation of special interest to North America (e.g., intellectual property rights, services, government procurement, etc.) could be low. The prospects for a successful FTAA could suffer as a consequence.

[7] Chile and Canada are suppressing antidumping measures in their new FTA.

Another advantage of an FTAA organized around strict and effectively binding disciplines for openness is that it could provide an escape valve for export to a large market should problems in the world economy begin to undermine open markets elsewhere. However, to afford this opportunity one must emphasize the paramount importance of commitments to openness only in this way could the experience of Latin America and the Caribbean during the crisis of the 1980s, in which regional markets suffered disproportionately, be ameliorated.

{PRIVATE }*Preparation for World Class Competition and Globalization****{****tc \l 3 "Preparation for World Class Competition and Globalization"****}***

Through unilateral, multilateral and sub-regional liberalization Latin American and Caribbean governments have been using increasing import competition as a tool for inducing economic transformation (IDB [1996a]). The FTAA promises to open markets much further and induce more head to head competition from world class firms in North America. Indeed, opening to North America, given its size and competitive strength, has effects, which parallel in some ways a market opening to the world economy. Preparation for this competition, and the gradual intensification thereof, during a FTAA phase-in period will be a challenge for many national firms in Latin America and the Caribbean. But it also should serve as a major catalyst for microeconomic modernization of the economies. The difference between an opening through an FTAA and one that is unilateral with the rest of the world is that the FTAA offers the benefits of reciprocal liberalization in a legal framework of mutually agreed trade and trade-related rights and obligations. Moreover, the resulting source of high grade competition is more geographically focused (on identifiable North American firms), which conceivably could provide advantages in the formulation of effective strategic responses by nationals.[8] There is some evidence that NAFTA has served as a catalyst of microeconomic modernization and enhanced competitiveness in Mexico.[9]

{PRIVATE }*Attraction of Foreign Direct Investment****{****tc \l 3 "Attraction of Foreign Direct Investment"****}***

Foreign direct investment (FDI) can be a source of technological transfer, modern corporate practice and access to international export markets.[10] The presence of FDI also can serve to lock- in policy reform (Ethier [1998]. There is great competition among developing countries for this type of investment. The inflows of FDI to Latin America have grown substantially in the 1990s from US$8 billion in 1990 to US$46 billion in 1997. Indeed, prior to the Asian crisis Latin America captured more than one third of the fast growing total FDI flows to developing countries (Calderón [1998]).

As Ethier points out, developing country competition for FDI is sufficiently intense that significant distinguishing features in a country or subregion can be decisive in attracting

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8 Puga and Venables [1996] demonstrate that due to geography and externalities from agglomeration, liberalization in a preferential arrangement can provide greater gains in terms of industrialization than a unilateral liberalization.

9 See Sutler [1997]. The FTAA process and initiation of negotiations in 1998 is already raising awareness in Latin America of shortcomings in public and private preparedness regarding international trade.

10 However, as Winters [1997], and Garay and Bailliu point out, not all FDI carries net benefits. See Garay and Bailliu [1996].

investors, which tend to cluster, or locate together (Ethier [1998]). The economic literature recognizes that integration schemes can create an impact that attracts FDI. According to Blomstrom and Kokko [1997] the bigger the change in economic environment associated with the agreement and the greater (1997) the locational advantages of the country, sector, or subregion, the more likely the initiative will stimulate foreign investment from countries in the agreement and from third parties. An FTAA could be a magnet for foreign direct investment: it would create a preferential market of nearly 800 million people and 10 trillion dollars of GDP. This, coupled with possible lower risk premia due to the Latin America and Caribbean's locking into (see below) a rules-based agreement anchored by a subregion (North America) which investors traditionally consider highly credible, could be a basis for attracting considerable foreign direct investment. The pattern, however, is not unidirectional. Foreign direct investment that originates in the subregions which originate in the Western Hemisphere and is motivated primarily by the existence of margins of preferences may be withdrawn and be substituted by direct exports from the home country (Garay [1997]). On the other hand, foreign direct investment which is motivated primarily by locational advantages could expand in the hemispheric market. The FTAA could be a strong magnet for foreign direct investment from outside the hemisphere as well because of preferences of a large market and access, which is secured by a rules-based system. However, some existing extrahemispheric foreign investment could also relocate to exploit the redefined locational advantages of the bigger FTAA market.

As far as intrasubregional investment is concerned, it is difficult to know exactly what is happening due to severe data constraints. However, there are indications that this phenomenon is gradually becoming significant in an environment of open regionalism (Garay and Vera [1998]). In an FTAA this budding intraregional experience could be useful in the formation of alliances and investments that exploit geographical advantages for competing in the hemispheric and world markets.

{*PRIVATE* ***}****Widening and Deepening of Regional Integration****{****tc \l 3 "Widening and Deepening of Regional Integration"****}***

The FTAA will probably eliminate some regional agreements and contribute to others deepening and widening. The exact outcome will depend on the objectives and the political commitment of the member countries to their respective agreements. As we will see later, this is probably one of the more complex issues surrounding an FTAA. While not all developments in this area will be welcomed by all participants, there are scenarios, which would be largely positive for subregional integration, for the hemisphere and the world economy more generally.

An FTAA promises to enhance transparency and reduce transaction costs of hemispheric trade. Since the 1990s there has been a proliferation of new free trade areas in Latin America and the Caribbean. These new agreements have served to strengthen political ties, push the trade liberalization process forward, and contributed to growth of trade and investment and diversification of exports. However, the new agreements have created a complex web of tariff preferences, rules of origin and other disciplines which have reduced transparency in trade, altered investment flows and introduced their own transactions costs. An FTAA would probably supersede at least the simpler free trade areas, and -assuming it fulfills its promise of improving on the existing state of the art regarding the normative architecture of free trade areas- could thereby raise transparency and lower transaction costs in the hemisphere. However, as will be

discussed in the following chapter, the dynamics of this convergence process is complicated and will be aided or abetted by the direction of subregional and regional integration policy between now and 2005.
Since trade ministers in the hemisphere have agreed that only integration schemes with commitments deeper than the FTAA will continue to exist after 2005, there is every incentive for countries with political and economic objectives of deep subregional integration to fortify their community commitments as soon as it is politically feasible. Aside from the short term benefits of allowing the subregions to better coordinate and project joint positions in the FTAA negotiations, the longer term advantages of strengthened commitments are structural change, enhanced investment and competitiveness in the hemispheric and world markets as well as a more effective vehicle to promote a subregional agenda, which has a logic and legitimacy of all its own. Finally, since the FTAA will most likely be a strictly enforced rules-based system, in the longer term it could have positive demonstration effects on Latin America and the Caribbean regional integration which still must rely to a significant degree on diplomatic "informality".

On the down side, the negotiations and prospects of a hemispheric agreement could also have the effect in some case of distracting attention from subregional integration and stimulating conflictive opportunistic behavior among subregional partners attempting to negotiate collectively the FTAA. This would be highly unfortunate. We now know that successful subregional integration is never lineal. Hence the collective FTAA process must not unnecessarily aggravate problems in viable subregional agreements and it must find ways to flexibly accommodate conjunctural swings in the evolution of deep subregional integration schemes. However, in those cases where fissures reflect inherently weak political commitment and systematic unfulfilled promises of subregional integration, the chances of deepening would not be good anyway and absorption by an FTAA may be in everyone's interest.

{**PRIVATE **}**Strengthening the Multilateral System**{**tc \l 3 "Strengthening the Multilateral

*System"**}***

For Latin America and the Caribbean, a healthy and developing multilateral system is strategically essential; after all, as was seen earlier, the extra hemispheric market is still primary, or very important, for all but a few countries. However, some trade specialists argue that regional integration is a threat for the multilateral system. The FTAA is especially alarming from their perspective because of its overall size and the participation of North America (Bhagwati and Panagariya [1996]).

One cannot dismiss risks in this area. Large regional integration schemes can improve the terms of trade of member countries at the expense of non-member countries and give rise to incentives for maintaining or increasing preferences and protection. An FTAA can also create defensive reactions on the part of third parties. This would be benevolent if it emerged in the form of a push for a consensus on a new ambitious multilateral round that would in effect erode FTAA preferences. But another possibility is that a defensive reaction emerges in the form of others seeking to widen and deepen their own bloc at the expense of the multilateral system.

In any event, it can be argued that in the current policy environment the risks are overstated. Indeed, in today's context of open regionalism, regional integration can serve as a catalyst for development of the multilateral system.

The FTAA process already has had some positive benefits for the multilateral system, e.g. the FTAA preparatory work has greatly increased transparency regarding the rules and norms of trade in the countries and sub-regions of the hemisphere.[11] Meanwhile, since the WTO is the agreed baseline for the FTAA, the same process is intensively exposing countries to the rights, obligations and procedures of the WTO and the Uruguay Round. The FTAA process has even exposed the WTO to better ways to facilitate country notification to that body.[12]

Will a serious FTAA negotiation facilitate or impede another multilateral agreement? This is a highly speculative question full of political uncertainties. The current FTAA negotiations parallel a more narrowly defined WTO built-in agenda (agriculture, services, IPR, etc) (IDB [1998a]), which could very well be expanded into a new multilateral round if there were a broad enough consensus to do so as increasingly seems the case. In the meantime the FTAA has helped countries prepare and exchange ideas and information that could be helpful in their WTO agenda (Otteman [1998]). In any event, since the Uruguay Round is still being digested and the political parameters for launching a new round are complex in the best of circumstances, it was not clear until recently that a new comprehensive round might emerge Also, without the FTAA North America might have returned to its original objective of bilaterally pursuing its trade agenda, which would ultimately aggravate the distortion of the hemisphere's hub and spoke matrix. Indeed, the fact is that for Latin America and the Caribbean the FTAA has been up to now the only available "big market" trade negotiation that can accommodate the trade-offs needed to advance in a broad spectrum of trade issues. Moreover, the voice of the region's countries and subregions in the FTAA negotiation is larger than it would be in a much bigger WTO forum.[13]

It is not implausible that there will be synergies between the WTO built-in agenda and the FTAA negotiations and that FTAA negotiations will serve one way or another as the handmaiden of a new multilateral agreement. Since the FTAA is a single undertaking and interests among the different negotiating topics are far from symmetric between North America and Latin America and the Caribbean, realization of any agreement will likely be better than the WTO in nature.[14] That is to say, in addition to the traditional tariff liberalization on "substantially all trade", to realize itself the FTAA may have to effectively address North American-Latin American and Caribbean trade-offs on a broader spectrum of their respective priority/sensitive issues agenda, leading to agreements in some areas that make the FTAA better and more balanced than what is available in the WTO. The specter of a better agreement, on or around 2005, could in turn help induce a world consensus for a

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[11] By the development and publication of systematic inventories and data bases on trade and trade-related issues that heretofore were unavailable or difficult to secure. The FTAA process has also inspired new research in areas where knowledge is very limited.

[12] The Inter-American Development Bank, in its FTAA technical support role, provided the FTAA Market Access Preparatory Group with a simplified system and software for notifying trade and tariff information. The relative success of this exercise contributed to the WTO overhauling its complex and unsuccessful Integrated Data Base, borrowing on some of the innovations that the IDB developed for the FTAA process.

[13] It is interesting that in the FTAA negotiations a number of smaller countries can be quite influential in the direction of discussions.

multilateral agreement, the evolution of which would be influenced by the innovations generated in the FTAA itself. Indeed, some past multilateral rounds have had their origin and evolution impacted by the developments in regional integration as outsiders see a round as a vehicle for reducing the preferences they face, or will face, and insiders see it as an opportunity to politically restate their commitment to multilateralism, and perhaps promote their new trade agenda reciprocally at the world level (Bagwell and Staiger [1995] pp. 1162-82). On the other hand, if a critical mass of sensitive/priority issues are not effectively put on the FTAA table, because countries prefer to negotiate them in multilateral fora, the FTAA could falter; hence, furthering interests in trade liberalization would be dependent on individual unilateral policy and sub-regional integration until a world consensus emerged on yet another new WTO round.

{PRIVATE }Lock-in of Policy Reform{tc \l 3 "Lock-in of Policy Reform"}

While economic policy change in Latin America and the Caribbean has been substantial, a successful and balanced FTAA could serve to make reversals more difficult. The importance of this policy instrument would vary greatly among the countries of the region. In any event, lock-in effects were a factor in Spain and Eastern Europe's link up with the E.U. and Mexico's participation in NAFTA.

{PRIVATE }Some Potential Negatives{tc \l 2 "B. Some Potential Negatives"}

While there are a number of potential benefits from an FTAA, there are potential costs too. Again, although these will be country specific, a generic check list -not necessarily exhaustive- can be developed from what is known in the literature and practice of new regionalism.

{PRIVATE }Adjustments {tc \l 3 "Adjustments "}

Liberalization of trade in the hemisphere is expected to create trade and generate efficiency gains. However, in the process of arriving at the full potential benefits of an FTAA, there are firm, sectoral, and social adjustments on account of the reallocation of resources induced by liberalized trade flows. The more heterogeneous the membership of a new FTA, and the more important trade is as a percentage of GDP, the greater the potential gains from creation of a regional market -but also the more pronounced the adjustment process will likely be. Hence, in an FTAA with very heterogeneous countries and many very open economies, important adjustments of considerable economic and social magnitude are likely. The costs of these adjustments will depend on many factors such as initial country conditions, the nature of domestic economic policy, and progress in structural reforms, exceptions (if any) and phase in periods for liberalization, the availability of adjustment assistance, etc. Some of these issues will be discussed below.

{PRIVATE }Asymmetric Distribution of Gains{tc \l 3 "Asymmetric Distribution of Gains"}

The FTAA membership will combine very heterogeneous countries in terms of their levels of development. Economic theory suggests that in principle liberalization of trade can promote

[14] Even a simple free-trade area is by definition WTO "plus" since tariffs are eliminated on substantially all trade.

convergence among richer and poorer economies. Moreover, there is some empirical evidence that this occurs (Ben-David [1996] pp. 279-98). However, the process has been observed to be extremely slow and uneven, even in relatively ideal conditions like the U.S. economy where free trade among states combines with the free movement of all factors of production and a degree of uniformity in regulatory frameworks and political institutions (Barro and Sala-I-Martin [1991] pp. 107-79). Thus, all being equal, in an FTAA there is the risk of skewed benefits, with some countries and regions gaining much more than others in the short to medium term.[15] There are ways and means to effectively counteract this problem if the member countries so wish to do so. However, if it becomes exaggerated, an uneven distribution of benefits could lead to political tension and stagnation of a trade agreement.[16]

A specific phenomenon identified in the debate over the FTAA is that the asymmetric structure of tariffs in the hemisphere can lead to serious redistributive effects between the North and South (Panagariya [1996]). As mentioned earlier, on average, tariffs in Latin America and the Caribbean (Table 1) are considerably higher than in North America (In 1997, the average tariff in the United States was 5 percent and in Canada was 7.5 percent). Consequently, in the process of preferential tariff liberalization, revenue from duties on imports from North America prior to the FTAA is effectively transferred to producers there as they capture margins of preference. This cost must be weighed against the benefits of entering an agreement.

{**PRIVATE **}**Trade and Investment Diversion**{**tc \l 3 "Trade and Investment Diversion"**}

Creation of preferences goes beyond technical issues and obviously has a political component. In principle this is not necessarily bad: a free trade area represents a compromise among parties with different interests and by definition is part of a second best world. To the extent preferences emerge endogenously as part of a collective process of trade offs, they can be the sign of a sustainable free trade agreement. An agreement among countries that exhibit significantly high tariffs on third parties, coupled with restrictive rules of origin, inevitably has some effect of diverting trade away from possibly more efficient firms that are located in non-member countries (Bhagwati and Panagariya [1996]). This has real costs and is part of the price of an agreement which presumably has its compensations for members; and if the agreement promotes sustainable growth, for the world economy as well. But awareness of the problem is important in order to minimize these effects. Meanwhile, to the extent that exploitation of FTAA preferences (including incentives provided by rules of origin) -rather than the transparency and comprehensiveness of disciplines of a large regional market- are the primary motive for foreign investment decisions, there are the risks that some direct investment activity will be diverted from more efficient third markets (Winters [1997]). Even if diversion of trade and investment flows is more than compensated later by the dynamic effects of integration, there are immediate up front costs for consumers and producers.

{**PRIVATE **}**Macroeconomic vulnerabilities**{**tc \l 3 "Macroeconomic vulnerabilities"**}

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[15] The more extensive the rules and their enforcement in an FTAA the more likely investment will spread and be based on a criterion that goes beyond the home country's local market size.

[16] Salgado [1979] attributes this problem to the stagnation of regional integration in Latin America in the late 1970s.

The FTAA disciplines will emerge in countries at very different stages of structural reform. Hence there is always the risk that in some instances the introduction of a new trade discipline(s) may involve less than optimal sequencing *vis-à-vis* the progress of other reforms. An example might be where the liberalization of financial services preceeds strengthening of domestic financial regulatory structures and/or where that liberalization and creation of the hemispheric market stimulates surges of capital inflows, which in turn generate pressures for a premature appreciation of the exchange rate and weakened trade and balance of payments performance in the new FTAA (Devlin, Ffrench Davis and Griffith-Jones [1995]).

{*PRIVATE* ***}****More interdependence* ***{****tc \l 3 "More interdependence "****}***

While integration schemes provide benefits for participating countries, they also create new interdependencies that may erode autonomy to some degree. With an FTAA new interdependencies will be created; some will be appreciated and others may not. Since the North American market will naturally be an anchor for an FTAA agreement, one can expect that Latin America and the Caribbean will to a greater extent be under the commercial influence of their Northern neighbors. The interdependency could provide benefits -e.g., policy lock-in and investment effects, more formal capacity to influence North American trade policy, capacity to organize balance of payments assistance, and so on-, but also be accompanied by more North American commercial vigilance and perhaps indirectly intensify exposure to particular unilateral non-commercial policies emerging out of this geographic area in subjects such as drugs, labor and the environment, etc.

The FTAA Membership Matrix: Potential Impacts and Their Distribution

Although the various positive and negative aspects arising from the FTAA will in some way touch virtually all of the countries in region, the relative magnitude and distribution of impacts will weigh differently in different regions and at different times during the phase-in process (lasting from 2005 to perhaps 2020) and the subsequent process of operational consolidation. This is especially true given the relatively heterogeneous nature of the FTAA participants, as noted above.

Some of the main structural factors at the country level that will determine the nature and time frame of the impact of the FTAA are:

- level of development and capital accumulation;
- access to social instruments which facilitate market opportunities: distribution of income, education and training, access to credit and its cost, protection of property rights, democratic institutions, etc.;
- intra and extra regional patterns of specialization, complementarity, and sectoral productivity/competitiveness;
- locational advantages and degree of natural integration with major market hubs in the hemisphere;
- degree of openness to the world economy, export diversification, level of real exchange rate, and tariff and non-tariff protection vis-à-vis third parties;
- completeness of infrastructure networks;

- degree of progress in the process of structural reform at the macro, micro, and meso levels which will influence inter alia, productivity and risk premia;
- dynamism and depth of the sub-regional integration scheme to which the country belongs (where applicable);
- availability of commercially attractive reciprocal and non-reciprocal extra-regional trade agreements;
- degree to which national strategies converge with the new FTAA normative architecture;
- macro-economic stability.

In addition, specific conditions existing in the world economy will impact on all countries. These include:

- global growth rates;
- systemic stability relating to capital flows to developing countries;
- evolution of world commodity prices;
- openness of the multilateral trading system.

The size and distribution of benefits of the FTAA will also depend on the architecture of the Agreements:

- the scope and depth of the disciplines in the Agreement;
- the degree of speed and sequencing regarding the incorporation of new disciplines;
- the degree of reciprocity and/or (a-)symmetric treatment between countries: distributional policies, regional cooperation, and effective creation of opportunities.

In order to illustrate some of the possible differential impacts among member countries, some indicative examples follow:

1. Level of development and capital accumulation in conjunction with access to social instruments which facilitate market opportunities: distribution of income, education and training, access to credit and its cost, protection of property rights, democratic institutions.

   The more developed and diversified an economy, the relatively better positioned it is to realize the maximum possible degree of benefit arising from the FTAA with less difficulty in successfully sustaining the adjustment costs that will arise. Relatively less developed economies may face greater challenges in this regard. This, in turn, may be aggravated by both the serious income inequality that exists in certain parts of the hemisphere and the narrow economic base of a number of member countries.

2. Degree of openness to the world economy, export diversification, protection vis-à-vis third parties, intra/extra FTAA patterns of specialization, natural integration with major market hubs in the hemisphere.

The more open to the world economy, the more diversified in terms of exports of goods and services, and the greater the proximity to the largest hub markets in the hemisphere, the better positioned an economy is to benefit from the expanded trade, potential diversification, specialization, and competitiveness arising from the FTAA.

3. The more advanced the structural reform and economic stabilization process, the lower the degree of trade protection, and the higher the degree of competitiveness, all being equal, the better placed an economy is to benefit from the FTAA.
4. The more effective the creation of "opportunities", particularly in less developed countries, the lower the likely degree of inequality among countries in terms of the distribution of benefits and costs arising from the FTAA.

Given the variety and complexity of factors and conditions that will affect the impact of the FTAA at a country level, the specific distribution of net benefits can not be easily predicted.

Policy Issues

While the above checklist of the potential cost and benefits of an FTAA is a priori, generic and far from exhaustive, it highlights some of the strong economic and political tradeoffs that countries could confront as they enter an FTAA. These and other cost and benefits would play out over an extended period of time with the costs weighing in heavily at the initiation of the process. To the extent that the FTAA is successful, these costs should be more than compensated by benefits in the longer term that generate growth and realize other objectives. How costs and benefits play out in practice also will depend on, inter alia, the negotiated architecture of the FTAA disciplines and institutions and the time path of their implementation; the interface between national and subregional economic policy and the FTAA as well as the play of exogenous factors in the world economy. This subsection highlights a generic checklist of collective hemispheric and national policies which in principle could tend to maximize benefits and minimize costs of an FTAA. Again the relevance of the checklist and its components will vary for each country according to its individual circumstances and the final outcome of an FTAA agreement.

Collective Network

While avoiding cumbersome bureaucracy and costly infrastructure, it is nevertheless imperative that the FTAA develops a coherent and functionally comprehensive institutional network that allows all countries to exploit fully their rights and opportunities as well as monitor and enforce (in a constructive way) the obligations of the FTAA. Not knowing the precise scope and normative architecture of the FTAA inhibits precise comments about this issue. However, among the direct and indirect mechanisms, which should emerge in or around the FTAA are: (1) a fully transparent and participatory dispute settlement mechanism which builds on innovations found in the WTO; (2) collection and dissemination of information which facilitates the countries monitoring of their rights and obligations; (3) monitoring of the distribution of benefits of the FTAA, with special attention to the poorer economies; (4) interchange of information and perhaps degrees of coordination concerning certain aspects of national economic policies (e.g., macroeconomics, financial regulation, vigilance of capital flows), which have externalities *vis-à-*

vis countries' performance in the FTAA and affect the ability to deal with systemic problems in an ever more interdependent hemisphere; (5) adjustment and balance of payments assistance;[17] (6) technical assistance; and (7) public outreach to enhance civil society's understanding of the FTAA processes and trade issues more generally.

National Macroeconomic Policy

A sustainable macroeconomic environment is fundamental in order for a country to compete and capture the full potential benefits of any economic reform or a trade initiative such as the FTAA. Latin America and the Caribbean have made much progress in reforming macroeconomic policy (IDB [1996b]). However, in Latin America and The Caribbean the sustainability of macroeconomic balances has been adversely affected by international capital flows which are increasingly volatile, unpredictable, and prone to contagion. The volatility is indeed quite impressive. In this environment a strong influx of capital cannot be necessarily interpreted as a signal of the Market's commitment to a given macroeconomic policy stance or can an outflow be necessarily interpreted as confirmation of poor fundamentals.[18] Since capital flows affect the level of aggregate expenditure, trade balances and the real exchange rate, the volatility that is being observed in international capital markets is of fundamental concern for the stability of an FTAA and the ability of countries to maximize their commercial opportunities. More specifically, the volatility of capital flows greatly aggravates macroeconomic management and is conducive to cycles of excess expenditure, crisis and over adjustment, which in turn is unhealthy for growth, stability, free trade and integration.

While there is increasing public awareness of the problem of volatile capital flows, international initiatives are usually slow in coming. In the meantime, a defensive national macroeconomic stance that avoids leveraging an economy on volatile short term external capital may be the best defense to ward off the destabilizing effects of unpredictable reversals in the psychology of capital markets. Such an approach would aim at establishing a cautious macroeconomic policy stance that, coupled with international reserves, would allow a country to make non-traumatic adjustments should capital flows abruptly slow down or dramatically reverse themselves. This would involve a policy mix of strong fiscal and monetary discipline; cautious external debt management, intervention in the foreign exchange market (reserve accumulation/sterilization and, when necessary, mechanisms to directly control, or better regulate, the flows of short term speculative capital) and very disciplined financial market regulation.[19] Such an approach could reduce the risk of abrupt macroeconomic adjustments and also could contribute to moderating appreciation of the real exchange rate, which protects incentives for domestic production of exports and import substitutes. Indeed, as countries enter into the FTAA, attention to the issue of competitive exchange rates (and even possible overshooting) will be important for facilitating adjustments and effective participation in the hemispheric market.

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[17] This function perhaps could be carried out by regional organizations.

[18] See Devlin [1989]; ECLAC [1995]; and Devlin, Ffrench Davis and Griffith-Jones [1995].

[19] Gavin and Hausmann [1996] argue that financial regulation should be even more disciplined than the Basle Accord.

Deepen and Widening Reforms

Latin America and The Caribbean have made much progress in advancing in their structural reforms. But effective participation in the FTAA will demand deepening and widening of this effort.

Trade liberalization. In recent years Latin America has made marked progress in opening up its economies. Yet MFN tariffs are still relatively high, especially *vis-á-vis* North America (Table 1). A program of further gradual reduction of third party tariffs would grant exporters cheaper inputs to compete head-to-head with the North. It also reduces risks of trade diversion and minimizes the redistribution of tariff revenue as FTAA preferences enter into force. Competitive pressures within the FTAA should contribute anyway to lower and converging tariff structures in the hemisphere. The effects of the Asian crisis, however, would probably demand more caution in pursuing MFN tariff liberalization. Indeed in the short term the real challenge may be to avoid or minimize reversals in the market opening up process in the region.[20]

Effective incentives for industrial reconversion and export. The FTAA will raise pressures for firms to reconvert in order to face intensified competition from their hemispheric partners. Macroeconomic stability will contribute to this process, but there will also be a need for programs to ensure access to credit and technology (especially for small and medium sized enterprises), labor retraining and placement, competitive bench marking studies, identification of market opportunities, export promotion, and so on.[21]

Infrastructure. Competing within the FTAA will require more coordinated policy and focus on developing modern infrastructure, not only at the national level but also between and among FTAA partner countries. Improving links among subregional partners is especially important since geography may award opportunities for combining factors of production and creating synergies that enhance competitiveness in the hemispheric market.

Social reform. Latin America is the most inequitable developing region in the world (IDB [1998b]). There is a growing consensus that severe inequality can be an obstacle to improvements in international competitiveness and growth. Progress in this area is essential to ensure development of the human capital needed to compete and ensure an equitable distribution of benefits from the FTAA within society. There also is a need for development of transparent and effective regulatory and judicial systems that create a national counterpart to a rules-based hemispheric trading system.

Modernization and coordination of trade related ministries. The ministerial architecture for trade issues in many countries still reflects the function of another era when Latin American economies were more closed, trade was less dynamic and multilateral and regional trading rules were less complex. Strengthening is now required in many areas including: implementing trade legislation; training to develop professional depth in the nations corps of negotiators, trade technicians and

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[20] Yet some countries like Chile have scheduled a second stage of MFN tariff reduction, from 11 to 6 percent over five years.

[21] Colombia has recently initiated an ambitious study program in this regard. See Garay et al. [1998].

lawyers; developing more capacity to analyze and evaluate options for trade liberalization and negotiation, understanding and implementing complex obligations and exploiting the full rights granted under trade agreements;[22] reinforcing inter- and intraministerial coordination; improving data collection and distribution; enhancing coordination, as well as strengthening rules and procedures for managing destabilizing trade imbalances is desirable for schemes with deep objectives. with the private sector and civil society more generally and promoting new exports, investment and market opportunities.

Deepen and widen subregional integration agreements Realization of objectives for deep integration in subregional schemes can, among other things, exploit geographic niches for hemispheric investment and export; enhance member countries' competitiveness in the hemispheric market; and provide learning experience and negotiating leverage now and in the future evolution of the FTAA. Given substantial interdependencies in some subregional schemes, and the importance of macroeconomic stability for trade performance, some systematic form of interchanging macroeconomic information, with an eye to eventual degrees of coordination, as well as strengthening rules and procedures for managing destabilizing trade imbalances is desirable for schemes with deep objectives. It also is helpful to pursue extraregional "new"integration agreements, because, apart from their inherent commercial and political merits, they may enhance bargaining power in the FTAA process, and contribute to developing a new multilateral round.

Participation in the multilateral system. A successful FTAA depends on its members complying with WTO obligations and pursuing deepening of the multilateral system. Of particular interest would be promoting another multilateral round and further defining and operationalizing Article XXIV rules guiding the relationship between the multilateral system and regional agreements. This latter consensual framework may help to minimize arbitrary evaluations of regional integration agreements and promote more homogeneous normative structures among them.

International solutions are urgently needed to tackle the destabilizing effects of volatile capital flows. Clearly Latin American and Caribbean countries must individually and together promote a dialogue with the G-7 to reform the international monetary system so that there is a better framework for a stable world economy in which countries and their integration partners can grow and prosper. There are already some interesting proposals on the table. However, it may be important for trade ministers to effectively participate in this dialogue directly, or through their finance ministers, because solutions in the area of finance are vital for open markets and trade.

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[22] One of the major areas of adjustment in Canada, when it entered into and agreement with the United States, was to mobilize a critical mass of trade lawyers accustomed to the aggressive, document-driven litigation techniques of U.S. lawyers in dispute settlement (Dearden [1996]).

{PRIVATE }IV. BUILDING THE FTAA:
TRANSITION, {TC \L 1 "IV. ARCHITECTURE OF THE FTAA\: TRANSITION, "}NEGOTIATION AND IMPLEMENTATION ISSUES

One of the policy areas for minimizing costs and maximizing benefits of an FTAA is its effective articulation of the FTAA with current and future regional agreements. The final chapter will elaborate more on this topic since it will be one of the central issues for a successful FTAA.

{PRIVATE }Some initial considerations{tc \l 2 "A. Some initial considerations"}

Given the multiplicity of trade agreements in the hemisphere and the bold decision of the heads of state in the Summit of the Americas to create an FTAA, it is essential that countries carefully design their negotiating strategies so as to take into account both subregional and hemispheric dynamics. In addition, special attention should be given to those countries, or subregions with greater political and economic influence in the hemispheric integration process. Unfortunately, the design of any integration strategy raises both theoretical and empirical problems that cannot be solved easily in practice. This is especially true given the coexistence of several basic strategies in the contemporary world trading system; namely, unilateralism, regionalism and multilateralism.

During the period leading up to the Summit of the Americas, several alternative approaches for hemispheric integration were under serious discussion (OAS/IDB/ECLAC [1994]). The first of these was to look for a convergence path among existing agreements already implemented or under negotiation. The second approach was the accession of all countries to a major subregional agreement. At the time, NAFTA was often promoted as a candidate for this type of expansion (Morici [1994]). The third option was the initiation of formal negotiations among the various countries, or subregions, in the hemisphere.

Although the last alternative was the option adopted at the time of launching the FTAA process, the other alternatives have played an important role in shaping the nature of the debate throughout the process. First, the concept of an FTAA, which will be constructed from existing agreements, has been part of the official ministerial language throughout the process (the "building bloc" approach). Moreover, efforts to widen and deepen existing bilateral or sub-regional agreements have run parallel to FTAA talks and, as such, have been explicitly acknowledged in the FTAA Ministerial Declarations as evidence of progress towards liberalization in the region. In the meantime, the option of NAFTA expansion has lost credibility on account of the failure of accession negotiations with Chile and failed fast track initiatives in the U.S. Congress. In contrast, as mentioned earlier, MERCOSUR has secured two important associate members by signing agreements with Chile and Bolivia and is moving to negotiate a free trade pact with the Andean Community. Moreover, Mexico, and Chile, are trying to consolidate their hub positions in the hemisphere with continuous efforts to secure new bilateral agreements.

All strategic options have to be evaluated in light of the long-term net social costs and benefits that the particular agreement brings to the member countries compared to those derived from other available alternatives. The net impact of any integration agreement will depend on the type and structure of the trade agreement: namely, the coverage, speed, depth and timing of liberalization; the selectivity and nature of rules and provisions; the treatment of "sensitive" topics; the application of mechanisms for the distribution of benefits among member countries, and so forth (Devlin and Garay [1996]). All of these issues are typical problems encountered when designing a "second best" policy.

The design of any integration strategy raises a "second-best optimization" problem. Moreover, in subregional strategies reaching for hemispheric scope -which is increasingly the case today in the Americas there are several alternative paths. If there is no "credible" multilateral cooperation mechanism among all the players, uncertainty will be further magnified and create a more difficult environment for an intertemporal valuation of alternative scenarios. As a result, it is even more difficult to make an "educated choice" among strategic options.

The fact that this situation resembles a “prisoners’ dilemma” for the FTAA participants and is conducive to a series of collective decision-making problems, may also lead countries to “overvalue” certainty and the benefits from a short-term perspective in decision making. Intimately linked to the foregoing is the fact that any empirical assessment of the relative benefits and sacrifices of each strategic option becomes much less certain.[23] The following factors can contribute to reduce this uncertain environment:

{**PRIVATE **}**Definition of a clear road map for the FTAA negotiations**{**tc \l 3 "Definition of a clear road map for the FTAA negotiations"**}

One of the major achievements of the FTAA initiative to date has been the collective efforts to design a framework and the road map for the process. This has been done by generating clear mandates from the highest national political levels (heads of state and trade ministers); developing a clear definition of the institutional structure (intergovernmental with technical support of the OAS/IDB/ECLAC Tripartite Committee); consensual principles of negotiation; comprehensive coverage of disciplines as part of a single undertaking, a precise set of terms of reference, preprogrammed performance benchmarks and time frames for different stages of the preparatory/negotiating processes; substantial built-in mechanisms for coordination, and the implementation and consultation with other economic participants (Devlin and Garay [1996]). As progress is made in developing these basic points of reference the climate of uncertainty is reduced, which will greatly facilitate the process of preparing countries and subregions for negotiations and development of strategies in anticipation of the FTAA.

{**PRIVATE **}**Consistency among bilateral and sub-regional initiatives**{**tc \l 3 "Consistency among bilateral and sub-regional initiatives"**}

Given the complexity of preferential agreements currently in place in the hemisphere, a high priority should be given to progressively encouraging the greatest degree of consistency and coherence among them via ex-post refinements. The same holds for new agreements. Otherwise, there is a risk of reproducing conditions conducive to less transparency in the liberalization process, high distortions in competition among member countries, and the insufficient use of the advantages of specialization. If this happened, it would constitute a move away from the observance of the basic principle of “open regionalism” which has characterized regional developments in the hemisphere.

The current situation has seen an increase in the number, variety and types of agreements, as described earlier. The evolution towards a *de facto* hub and spoke system -all things being equal- implies:[24]

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[23] This situation has been illustrated by various authors, such as Hinojosa, Robinson and Lewis, by means of a computable general equilibrium model. In this case, different scenarios in the process of forming an FTAA were analyzed, in the wake of alternative agreements among “regional Blocs” in particular, NAFTA, MERCOSUR, and the Andean Community. See Hinojosa, Robinson and Lewis [1997].

[24] For more detail on the analytical framework of hub and spokes, see R.J. Wonnacott and P. Wonnacott [1996].

- the intensification of the search for rents by economic agents in member countries -for example, national or multinational enterprises that plan to consolidate a mono or oligopolistic position in the regional market, restricting the entry of new competitors-;

- the progressive loss of resources because of efforts involved in negotiating, administering, and verifying compliance in each and every agreement -especially where there are overlapping provisions contained in agreements-;

- more onerous conditions for liberalization thanks to the relatively higher leverage of a "large hub country" in a bilateral context as opposed to one that is strictly plurilateral -that is, to negotiate with each "spoke country" individually rather than with all the countries together- which can also lead to granting greater protection relative to the predominant interests of the "hub country;"

- the restriction of the potential investment in all countries together -at least in comparison to an "ideal" situation of multilateral free trade- and, as a result, regional income, savings and growth because trade barriers remain among some countries namely- the "spoke countries" of the hub and spoke system- without being able to determine *a priori* the distribution among countries.

In this respect, as we mentioned earlier, the establishment of a free trade area in the Americas with "subsidiarity" for shallower FTAs agreements, and including a range of some disciplines that go beyond trade in goods, could contribute to the "rationalization" of all the FTAs and integration arrangements in force in the region and also to some degree of adaptation among those with which the FTAA will coexist.

{PRIVATE }Further consolidation of existing initiatives{tc \l 3 "Further consolidation of existing initiatives"}

Finally, the relative weight that each existing or future subregional agreement will have in the final design of the FTAA and the "rationalization" of the set of integration arrangements in the hemisphere will depend on several determining factors. These include:

- The degree of development of each subregional market, as well as the widening and deepening of the disciplines in the integration process that goes beyond trade in goods and reflect the spirit of the new regionalism which the FTAA represents.

- The consolidation of the integration process and its projection as a geopolitical and economic arrangement with a sense of identity and with the decision-making capacity to engage in broad agendas of economic and political cooperation at hemispheric and international level.

- The conclusion, in the next few years, of new generation FTAs among groups and/or countries in the hemisphere which anticipate as best possible expected characteristics of the future hemispheric agreement.

- The strengthening of bilateral relations with decisive hub countries or subregions in the areas of trade, investment, financing, and technological cooperation.

On the basis of such considerations, the next paragraphs outline some scenarios for the transition strategies that are available in moving toward the construction of the FTAA.

{PRIVATE }The Transition stage in the negotiation of the FTAA{tc \l 2 "B. The Transition stage in the negotiation of the FTAA"}

It is important to start with a brief description of the existing pattern of evolution of the hemispheric architecture regarding regional integration agreements, which, if it continues unaltered, would be the stage on which the FTAA enters into force.[25] With this assumption, the picture that emerges just before the year 2005, may be the following:

- Consolidation of the most advanced "new generation" FTA (NAFTA) in the Americas. This FTA would cover a broad range of disciplines such as trade in goods and services, investment, government procurement, intellectual property, subsidies, antidumping and countervailing duties, comparable, to or better than those of the WTO. In addition, it would contain partial preferential regimes in favor of the Caribbean countries and GSP clauses applicable to the rest of the Americas. However, this agreement would not have been expanded because of domestic politics in the United States and because of the strategic preparations for the negotiations of the FTAA.

- One of the two "hub-groups in the hemisphere" (MERCOSUR) would have achieved trade liberalization with the rest of South America under "first generation" type agreements, focused basically on trade in goods and with rules in market access similar to their own (for example, rules of origin similar to those in the MERCOSUR-Chile agreement). That would constitute a sort of South American FTA although less deep than the prevailing subregional arrangements in the area (the Andean Community and MERCOSUR are customs unions in the process of consolidation and deepening, but so far with disciplines narrower than the ones contained in the "new generation" FTAs.) In this context, at least in principle, MERCOSUR" as a hub subregion, would be expected to strengthen its bargaining power in the design and structure of the FTAA.

- At the same time in both North and South America some "subordinate" hub-countries or groups, because of their status as spoke countries or groups in the hemispheric context, would have consolidated their position within their existing integration processes with other Latin American countries. Such will be the case of:

[25] This scenario does not take into account extrahemispheric dynamics, which can potentially be very important and make the picture more complex.

(a) Mexico with its “new generation” type FTA system with Central America, Chile, and some Andean countries;

(b) Chile with Canada, Mexico and Central America under “new generation” FTAs, and with several Andean FTAs similar to “first generation” schemes.

(c) The Andean Community with FTAs with Chile and several Central American countries by means of “first generation” type FTAs, as well as with MERCOSUR although with significant differences in certain rules and disciplines such as rules of origin, and with CARICOM in “ asymmetrical” agreements; and

(d) The CACM with “new generation” agreements with Mexico, Chile, the Dominican Republic and Panama and a “first generation” agreement with CARICOM.

In the area of traditional market access, the status of trade liberalization for a selected number of FTAs is illustrated in (Table 7). Under this hypothetical situation it is useful to specify some basic guiding principles for the process of transition and coordination among the countries and “blocs” for the formation of the FTAA.

First, after heated debate in Belo Horizonte trade ministerial, it was agreed that the FTAA would coexist with deeper subregional agreements. As a result, shallow FTAs could be superseded by the basic regulations of the FTAA. In this respect, a decision must be taken on how shallow agreements will be phased out. The decision must take into account the burden of additional administrative costs (e.g., firms and customs authorities will be under two overlapping rules of origin regimes).

Second, in those cases where subregional integration is more profound in terms of objectives, scope and coverage than the FTAA, the problem arises as to the definition of those requirements that will ensure compatibility and coherence in conditions of competition among different regional arrangements and between them and the FTAA (for example, between the levels of preference among the subregional regimes and between them and those of the FTAA). Otherwise, distortions and inequities would be created in the conditions of competition in the hemispheric market unless the decision was made to opt for the formal harmonization of competition, promotion and development policies among the member countries of the FTAA.

TABLE 7
SELECTED TRADE LIBERALIZATION PROGRAMS IN THE AMERICAS

Agreement	Bilateral Trade	Bilateral Trade Liberalization			
		% bilateral imports of total imports	% items liberalized		% bilateral imports liberalized
		1995	**1996**	**2006**	**1995**
Chile-Mexico	Chile-Mexico	14.9	95.5	98.4	98.8
(1992)	Mexico-Chile	28.3	95.0	98.2	97.8
Chile-Venezuela	Chile-Venezuela	5.6	0.7	96.6	41.4
(1993)	Venezuela-Chile	5.2	0.7	95.7	99.5
Chile-Colombia	Chile-Colombia	3.7	4.1	91.3	88.6
(1994)	Colombia-Chile	6.1	5.3	91.3	93.0
Chile-Ecuador	Chile-Ecuador	5.2	3.9	96.4	35.0
(1995)	Ecuador-Chile	8.9	5.1	96.1	98.4
G-3	Mexico-Colombia	5.5	7.6	90.9	95.5
(1995)	Colombia-Mexico	15.4	4.1	90.8	98.5
	Mexico-Venezuela	12.2	2.4	76.4	99.4
	Venezuela-Mexico	15.3	0.4	76.8	98.6
Mexico-Costa Rica	Mexico-Costa Rica	0.0	86.4	99.3	100.0
(1995)	Costa Rica-Mexico	4.0	73.2	97.8	98.8
Mexico-Bolivia	Mexico-Bolivia	0.3	61.8	96.5	99.9
(1995)	Bolivia-Mexico	3.6	59.2	96.4	98.9
MERCOSUR	Argentina-MERCOSUR	10.3	96.6	99.9	91.2
(1995)	Brazil-Argentina	21.5	99.4	99.9	99.7
	Paraguay-MERCOSUR	91.4	92.8	99.9	
	Uruguay-MERCOSUR	89.9	86.3	99.9	73.6
MERCOSUR-Chile	Argentina-Chile	8.8	4.4	94.7	63.5
(1996)	Chile-Argentina	34.3	4.4	95.0	32.3
	Brazil-MERCOSUR	11.2	4.4	94.7	58.1
	Chile-Brazil	29.6	4.4	97.6	32.5
	Uruguay-Chile	3.4	4.4	94.8	16.3
	Chile-Uruguay	1.0	4.4	95.4	47.6
	Paraguay-Chile	6.3	4.4	95.0	10.7
	Chile-Paraguay	1.4	4.4	93.5	82.3
MERCOSUR-Bolivia	Argentina-Bolivia	2.3	5.4	97.1	93.9
(1997)	Bolivia-Argentina	23.0	7.3	92.2	72.6
	Brazil-Bolivia	0.2	5.6	97.1	46.9
	Bolivia-Brazil	31.8	7.3	92.2	66.7
	Uruguay-Bolivia	0.1	4.8	97.1	79.0
	Bolivia-Uruguay	0.9	7.3	92.2	20.8
	Paraguay-Bolivia	0.2	5.0	97.1	
	Bolivia-Paraguay	0.2	8.7	92.3	26.7

Source: A. Estevadeordal (forthcoming)

One of the problems rests in the difficulties of empirical evaluation of those effects; in particular, distortions due to measures and regulations such as rules of origin as well as their distributive and resource allocation impact among countries (Garay and Estevaderodal [1995]). Therefore, following a "second best" policy type recommendation, it would be useful to undertake some adaptation of the regimes and conditions governing competition among countries and prevailing regional integration arrangements in the Americas.

Given the uncertainty associated with the transitional process, the differences among existing regimes and the diversity of participants in this process, the issue of timing with respect to the adaptation of remaining regimes in the hemisphere becomes central. This is even more important if one takes into account the negative effects resulting from inadequate investment decisions or reallocation of production and the loss of efficiency from not anticipating locational and scale economies in the new hemispheric integration matrix.

In principle, it is expected that the longer this situation of uncertainty lasts, the greater will be the probability of not seizing the full advantages of future integration in the hemisphere and subregion. Finally, certain powerful "regional groups" may seize the opportunity to consolidate their integration processes taking into account the disciplines negotiated under WTO agreements or some of the most advanced FTAs in the region, or the scope of the FTAA initiative defined throughout the ministerial declarations. Those groups will then be better positioned to face the critical stage of negotiations of the FTAA with greater bargaining power and also to improve the situation for the transition to the new conditions of competition.[26]

Furthermore, regional groups or "first generation" FTAs based mostly on the liberalization of trade in goods or that do not deal with a large number of the disciplines included in "new generation" agreements, could widen and deepen their FTAs with other countries or regional groups. MERCOSUR, the Andean Community, and the CACM are cases that illustrate this type of situation.

As a consequence, through a process of adaptation and coordination of regimes among groups of countries as they effectively move forward with the "rationalization" of their respective FTAs or customs unions prior to the definition of the FTAA, not only can they reduce inefficiencies and administrative costs, but they can also create more favorable conditions so that such countries will exert greater influence on the negotiations of the FTAA.

Moreover, such rationalization will facilitate the environment for the adaptation and harmonization of different integration arrangements in force while the negotiations of the FTAA are held and can create the conditions for a more efficient negotiating process, where special attention will be focused on the definition of the FTAA in central fields as, for instance, market access.

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[26] One of the characteristics of a hub-and spoke network is the advantage awarded to the hub vis-a-vis the spokes and third parties in regard to preferences and conditions of competition. These advantages increase for the hub with the widening and deepening of its network. Likewise, there is a corresponding increase in the influence of its model of integration with third parties and presumably the collective FTAA process. In this regard it is interesting to point out the role Mexico is acquiring as a member of NAFTA, which is rapidly constructing a hub-and spoke network of new-generation FTAs with Central and South American countries while at the same time actively participating in an FTAA process, which has a "new-generation" agenda.

Under this scenario two factors must be taken into account. First, which regimes will be adopted as the reference benchmark for this process of adaptation. Second, how compatible will be the chosen regimes with the ones being negotiated in the FTAA. However, the FTAA regimes under negotiation will be, in turn, greatly affected as a critical mass of countries and groups move forward into this adaptation process.

One of the difficulties for convergence is the choice of reference regimes which contain clear criteria for comparing and selecting alternatives and are also sufficiently precise, transparent and predictable that their application will not obstruct the process of liberalization.

The existing WTO trading regimes must necessarily serve as one of the key reference points for the analysis of the FTAA architecture. Obviously, this does not imply that the FTAA will deepen those obligations subscribed to under the WTO in each and every one of the disciplines considered. This will probably happen in some cases but not in others. The final outcome will depend on the negotiations and the degree of progress and harmonization achieved by the most advanced "regional groups" in the hemisphere.

The problem in selecting the reference regime may be illustrated with the rules of origin. In the Americas, at least four basic origin regimes are being applied: (1) that of NAFTA and the “new generation” FTAs concluded by Mexico and Canada with other countries in the Hemisphere; (2) that of ALADI -as the “first generation” reference regime- for all the partial scope agreements between the signatory countries of the Treaty of Montevideo, for the Andean Community, and the FTAs of Chile with Colombia and Venezuela; (3) that of MERCOSUR for the FTAs with Chile and Bolivia, and eventually the FTA to be concluded with the Andean Community; and (4) that of the CACM as the intermediate regime between “first and new generation” regimes. Moreover, the non-preferential regime being negotiated in the framework of the WTO seems to be tending toward an intermediate framework, based largely on the criterion of change of tariff classification, but with a different degree of stringency between types of goods and using other criteria in those cases where it is necessary to specify origin requirements. Given these circumstances, there arises the issue of which would be the most suitable reference regime to be used in the adaptation process prior to the design of the FTAA.

In this particular example, a necessary though not a sufficient condition in order to achieve the greatest efficiency and the lowest transition costs is the adoption of some basic principles, such as: transparency and predictability, low administrative costs in the application of origin; small number of criteria for classifying origin; a definition of the degree of stringency that will not be higher than that those in effect among the countries previous to the FTA’s formation and the non-application of rules of origin in those cases where national tariffs to third countries are sufficiently low (for instance, say below 3 to 5 percent) or where they are similar.[27]
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[27] See Garay and Cornejo [1998]; Garay and Quintero [1997]; and Garay and Estevadeordal [1995].

V. CONCLUSIONS{TC \L 1 "

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The FTAA has been fathered by a convergence of interests in the hemisphere; on the one hand, North America's acceptance of regional integration as a policy tool which is complementary to the multilateral system; on the other, Latin America and the Caribbean's combining their long held interest in regional integration with a new market-based open economic strategy that has fostered a new regionalism and been an important contributor to a stronger multilateral system. The new regionalism has been a positive influence on Latin America and the Caribbean in the 1990s, helping to promote consolidation of economic reforms, creation of new markets and trade, preparation for globalization, strengthening of democratic regimes and fostering of regional cooperation.

The FTAA process is a complex venture that undoubtedly bears costs. However, an FTAA could also establish an important new framework of opportunities for regional integration, hemispheric cooperation and growth. Among other things, it could offer the possibilities of (a) more secure hemispheric market access; (b) a challenging incentive for productive transformation and preparation for globalization; (c) a potential magnet for new FDI; (d) a rationalization of existing strategies of regional integration; (e) synergies that contribute to a stronger multilateral system and (f) externalities which help to lock-in policy reform.

However, there is a whole spectrum of policy and strategic issues "around" and "outside" of the FTAA process as such that will condition the outcome and effects of the agreement, the ability of participants to maximize potential opportunities and minimize costs, and ensure a reasonable balance in the distribution of benefits among partner countries. In this regard, this chapter has presented a short, and far form all inclusive, check list of some longer term collective hemispheric and multilateral issues as well as macro, micro and mesoeconomic national ones that might merit special parallel attention as the formal FTAA negotiations progress.

The national issues are many and diverse. Macroeconomic stability is a *sine qua non* for effective participation in the FTAA. The volatility of short term capital flows has, however, become a major threat to macroeconomic stability in the developing world. In view of the fact that international solutions may be slow in forthcoming, countries may have no other choice but to establish an especially defensive policy stance -pragmatically deploying direct policy instruments when necessary- in the face of surges of short term capital flows. The goal would be to ensure sustainable macroeconomic balances that can support participation in the FTAA's opportunities and accommodate, without trauma, the changes in the psychology of capital markets. However, sustainable macroeconomic balances are not enough; one must address sectoral issues, such as the future strategy of trade policy vis-a-vis the rest of the world and areas involving micro and mesoeconomics -at the level of financing, domestic and foreign investment, human capital development, science, technology and productive resources, physical and institutional infrastructure, public and private coordination, and so on. The future direction of subregional integration is another strategic policy tool for exploiting the opportunities of an FTAA. Only with the creation and exploitation of dynamic competitive advantages, using the possibilities of

complementarity and specialization (including opportunities for deep subregional integration) with innovation and technical progress, and with the improvement of competition, can the potential of an integration process such as the FTAA be fully realized.
Also on the checklist are collective issues such as development of a functional, pragmatic hemispheric institutional ‘‘network” that directly or indirectly supports an FTAA; there also is a need for national promotion of strategic agenda in multilateral fora: the WTO and any international dialogue that may emerge with the G-7 over the years on solutions to the problems of greater volatility of international financial flows. In the absence of national and international approaches to effectively deal with turbulent international financial markets, ambitious trade initiatives, whether at the national, the subregional, hemispheric or multilateral level, could be in jeopardy.

In the chapter, particular emphasis was placed on the fact that the successful creation of a transparent and more effective hemispheric market will depend on the progress achieved in the adaptation and “rationalization” of the existing integration arrangements in force in the Americas, as well as the final outcome of an FTAA agreement characterized by a set of rules and disciplines that are broadly consistent with “regional groups,” member countries of the groups, and the remaining countries in the Americas and extrahemispheric arrangements. This would permit, inter alia, more efficient adaptation between a new FTAA and prevailing integration arrangements, deepening of “open regionalism” in the hemisphere, and generate more favorable conditions for facing future progress in the liberalization of competition at the multilateral level.

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