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STRATEGIC OPTIONS OF COMMERCIAL POLICY FOR CENTRAL AMERICA

BASIC GUIDELINES

1995

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**Strategic Options of Commercial Policy for Central America.
Basic Guidelines**

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Strategic Options of Commercial Policy for Central America.

Basic Guidelines¹

Claudio González-Vega²

I. Introduction: Celebrating NAFTA

In Central America, the political debate in Mexico, Canada, and particularly the United States, preceding the agreement on a North American Free Trade Area (NAFTA), was followed with considerable interest and, on the night of November 17, 1993, when the agreement was finally ratified by the U.S. Congress, there was an almost generalized sense of celebration. Such enthusiasm, which from the perspective of some concerned observers was almost ironic, would require an explanation beyond the scope of this paper.

Part of the justification for the implicit optimism may have been, nevertheless, the fact that ratification of the NAFTA agreement was interpreted (with more or less caution) as a signal of the defeat of protectionist forces in the United States. This interpretation was partly due, in turn, to the obvious subordination, during the debate in that country, of concerns for the international consequences of the agreement to domestic political (electoral) considerations. This was (correctly) perceived as part of a growing trend towards more inward-looking, isolationist attitudes in the United States. The success of such views would have meant less opportunities for trade, discouragement of private capital flows, and reductions in public foreign assistance.

¹ Paper prepared for the Washington Office of the United Nations Economic Commission for Latin America and the Caribbean (ECLAC).

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Moreover, not only would most of the arguments concerning the potential economic impacts of the creation of the free trade area, advanced during the passionate debate, not resist the simple scrutiny of basic economic theory, but much of the discussion was colored by explicitly xenophobic postures. Particularly disturbing to the Central American countries were numerous claims (widely held during the electoral campaign) of U.S. job losses as a consequence of several preferential programs, such as the Caribbean Basin Initiative (CBI), of immediate interest to the region.

Clearly, the implications of NAFTA for the welfare of the Central American countries are substantial (although not yet completely understood), but such considerations did not play any role in the arguments of those who opposed ratification of the agreement. Instead, the success of such vocal forces (e.g., Ross Perot) would have appeared as particularly threatening to Central America and their defeat was thus a legitimate cause for celebration.

Protectionism in the United States has always been seen as an obstacle to increased economic welfare in Central America, even by those who would still support protection for the region's domestic activities. What represents a comparatively new attitude, however, is growing support of freer international trade, even if it means less protection to the national industries. To the extent to which the formation of NAFTA was perceived (correctly or incorrectly) as a movement towards freer world trade, this celebration also reflected new attitudes towards commercial policies in the region. Such views have been behind the promotion of the more outward-looking strategies of development adopted after the crisis of the early 1980s, while at the same time they have been further fueled by the success of the new policies.

From this perspective, ratification of the NAFTA agreement was implicitly recognized as a first step in an ideally rapid process of trade liberalization in the Western hemisphere. Indeed, NAFTA was viewed as just one more element in the implementation of the ideas advanced in 1990 by President Bush's Initiative for the Americas, calling for freer trade. Many thereby optimistically hoped that similar decisions would soon benefit other countries and, in particular, Central America. The expectation of the rapid progress of this sequence might have actually obscured understanding of the immediate costs to the region from the formation of NAFTA.

Indeed, the creation of free trade areas such as NAFTA has positive and negative effects on non-member countries (e.g., Central America), which broadly include: trade diversion, terms-of-trade changes, investment diversion, and the positive externalities associated with the "growth dividend." Trade diversion due to NAFTA will most likely imply reductions in Central American exports to Canada and the United States, as Mexican producers gain preferential access to those markets. Even more threatening, however, would be incentives to foreign capital to locate in Mexico rather than Central America.

On the other hand, the dynamic benefits of trade liberalization (from capital formation, industry specialization, and the ability to import specialized inputs, for example) may increase output growth rates in the member countries (Young and Romero, 1991; Kehoe, 1992). Such increase in growth rates was expected particularly for Mexico (Hufbauer and Schott, 1992), with the corresponding increase in demands for imports from Central America. Thus, the direction and magnitude of the net impacts from NAFTA on Central America were not well known and, given their uncertain nature, celebration was not unambiguously called for. The reactions may have been dominated, therefore, by the presumed victory of the U.S. anti-protectionist forces.

If this was the case, a key question, not explored in detail in this paper, would be the extent to which protectionism was really defeated by the ratification of NAFTA. There is no doubt that the approval was a blow to Ross Perot and other demagogic politicians who attempted to use the debate for electoral gain, whose voices were at least temporarily discredited. From a political economy perspective, however, the key protectionist threat comes mostly from powerful vested interests (firms and workers) potentially hurt by a reduction of U.S. protectionism.

Such vested interests were evidently present during the negotiations of the agreement and might have been able to shape many elements (rules, time tables, lists of exceptions) of the final accord. This is not surprising. Commercial policy in the United States, as elsewhere, has been significantly influenced by lobbies that utilize the political arena to gain and defend protection for their activities from foreign competition (Baldwin 1984, 1985). These vested interests were already present in earlier decisions about preferential agreements favorable to Central America, such as the CBI. They represent the interests most threatened by free trade from the region, corresponding to activities in which the Central American countries possess comparative advantages.

Contrary to the expressed intent of these programs, the Generalized System of Preferences (GSP) and the CBI systematically biased United States imports from the area away from manufactured consumer goods, agricultural products, and textiles, apparel, and leather goods (Ray, 1987). This was particularly the case of imports into the United States facing declining, low productivity industries. Ray (1981) found that effective protection in the United States was higher for industries using low-skill, labor intensive methods of production, while Marvel and Ray (1983) also found that protection was higher for industries experiencing slow growth.

These historical patterns of protection in the United States have been sustained after the granting of preferences (such as the CBI) through the adoption of non-tariff barriers (NTB) to trade (Ray, 1989). Additional research would be needed in order to determine if the strength of these protectionist lobbies has actually been weakened by the NAFTA agreement. To the extent to which they contribute to continued high rates of protection despite NAFTA, which may not apply to Mexico, they increase opportunities for trade diversion away from Central America.

Celebration of the ratification of the NAFTA agreement was thus seen by many as the first act of a longer, hemispheric, trade liberalization play. Moreover, freer trade was viewed as the natural sequel to both the strict conditionality that had characterized substantial amounts of foreign assistance during the 1980s and the accompanying transformation of the Central American economies during the second-half of the decade. If indeed this was a signal for freer trade to come (and for aid levels to decline), it did have tremendous importance.

A second, critical question would thus be the expected speed and depth of implementation of this hemispheric process of trade liberalization. The answer to this question is not evident. The NAFTA debate extracted a high political cost from the Clinton administration, which became understandably reluctant to lose additional political capital in pursuing new trade agreements. This was reflected for some time in no more than subtle and diffused promises to lower hemispheric trade barriers. Although the Miami Presidential Summit's commitment to a Free Trade Area for the Americas by the year 2005 introduced an explicit agenda leading to this outcome, those celebrating the ratification of NAFTA in November, 1993 may have had a more rapid accession process in mind. Moreover, unexpected political changes in the United States may delay (or accelerate) such an outcome.

From the perspective of this paper, a most important cost from the ratification of the NAFTA agreement has been that the Central American countries today face a considerably more difficult set of policy choices than before. With the creation of NAFTA, not only is identification and quantification of the potential impacts of the agreement quite a difficult task for the limited technocratic resources of the region, but its adoption further complicated the strategic commercial policy choices that these countries face. Understanding the basic nature of these complications is the purpose of this paper.

II. Second-Best Solutions and Strategic Choices

The commercial policy choices faced by the Central American countries today are more difficult than ever for the following reasons.

First, in principle, since all the conditions for (constrained) Pareto optimality are actually not being met, such policy exercises are inevitably second-best games. Conceptually, the resulting suboptimality implies several consequences:

- (a) Although still powerful as a tool for policymakers, the authorities can expect more limited guidance from economic theory in these cases than they can from predictions about first-best outcomes. In these circumstances theory still matters, but it is not enough.
- (b) The correct (sub-optimum) policy choices will also depend on the nature of the (empirical) initial conditions, including the opportunities and constraints introduced by NAFTA.
- (c) Although theory can serve as a guide for the identification of the initial conditions that matter, relative magnitudes (of the relevant elasticities, propensities, and other parameters) need to be measured in each case and their expected changes forecasted. In many instances, measurement and/or forecasting problems may be unsurmountable.

- (d) Resource reallocation impacts resulting from policies and shocks, even when estimated with the most sophisticated of available instruments (such as advanced computable general equilibrium models), depend on critical assumptions and on the correct approximation of the actual elasticities.
- (e) Such elasticities are not independent, moreover, of the particular policy choices made (Lal, 1987; González-Vega, 1989). Willingness to invest in a new activity, willingness to innovate, willingness to take a particular risk (which, in turn, determine the magnitude of relevant elasticities) differ according to the policy scenario chosen. That is, such elasticities are endogenously determined, jointly with the choice of development strategy and associated policies. Questions must be asked about how particular policy choices are expected to influence the magnitude of those elasticities and other parameters.
- (f) To the extent to which answers about the most appropriate policy choices will be of the type "it depends," they may not necessarily be the same for all of the countries. To the extent to which the initial conditions in the Central American countries are sufficiently similar, however, one would expect suboptimal policies not to be different among them.

Second, another reason for the complexity is that these inevitably second-best decisions must be made in the presence of domestic and international constraints that are not given (constant), but that are volatile, uncertain, and difficult to predict. Events such as the ratification of NAFTA modify the countries' initial conditions and increase uncertainty, in this case about the rules of the game for continued and enhanced access to the region's most important market: the United States. Thus, in the presence of shifting constraints, suboptimal choices must be subject to frequent revisions. All of this adds to the costs of arriving at the correct policy choices.

Recognition by the authorities of the implications of departures from first-best situations is undoubtedly important for them to better understand the actual nature of the policy options faced. In some important cases, such recognition should actually shape specific choices. This would be particularly true in decisions about joining customs unions and free trade areas, when there are credible fears of substantial trade diversion.³ Recognition of such second-best results should have accompanied a more cautious reaction to the ratification of NAFTA, as well.

In general, however, practical application of optimum intervention rules in second-best circumstances is not easy and may become actually non-operational. First, the correct policy choices require the identification of the precise nature of the deviations from the conditions for Pareto optimality, as well as measurement of their extent (Bhagwati, 1968).

Second, governments must possess the administrative mechanisms required to implement policies in a non-distorting manner. Establishing a technocratic machinery and the institutions necessary to carry out the desired second-best policies is not a simple task (Krueger, 1994). All types of technical problems of administration must be resolved, while incentives and mechanisms are weak or lacking to induce public entities to achieve efficiency and low-cost outcomes. Private agents have incentives as well to falsify or conceal information, creating problems of incentive incompatibility. In this context, assumptions about the capacity of governments to intervene correctly become as heroic as assumptions about the complete absence of market imperfections.

³ As is well known, these arrangements remove obstacles to free trade among member countries, leading to welfare-improving trade creation, but retain obstacles to trade with the rest of the world, leading to welfare-reducing trade diversion. This led to the generalization of the second-best principle which states that in a world in which there is more than one distortion of free market equilibria, the elimination of one of the distortions does not necessarily improve welfare (Lipsey and Lancaster, 1956).

Fortunately, the most important arguments about the desirability of freer trade are not necessarily based on the (comparative) static resource reallocation effects that constitute the realm of first-best neoclassical economics or second-best optimum intervention theory. Rather, they reflect the significant dynamic implications associated with an increased openness of the economy, recognized by Adam Smith and other classical economists. These dynamic implications should constitute the first general guideline for policymakers.

III. The General Case for Free Trade

According to the static case for free trade, the removal of barriers to foreign transactions expands a country's set of feasible consumption possibilities. It does so by providing an opportunity to transform domestic resources into goods and services so valuable to the rest of the world (e.g., coffee) that the country's purchasing power expands. This allows a higher level of income per capita, but from this static perspective it does not guarantee a permanently faster rate of growth of the economy (Lucas, 1985).

That countries with more open economies have generally shown a better growth record is only a confirmation of the importance of trade's dynamic effects (Lal and Rajapatirana). Trade is important particularly because it promotes an economic environment that encourages entrepreneurship, innovation and creativity, the acquisition and use of knowledge in increasing productivity, risk taking and thrift, and the ambition that leads to work harder and the pursuit of other economic goals. These are the non-quantifiable determinants of growth that critically influence the residual not captured by the traditional factor of production accumulations. If this is the case, one can explain the stylized fact of a statistically significant positive relationship between income growth rates and the importance of exports in gross domestic product.

Openness introduces new sources of economic discipline for both private and public sector entrepreneurs (González Vega, 1992). In facing increased competition, private sector firms can no longer be complacent about costs, product quality, and market services. They can no longer waste substantial resources in lobbying and other directly unproductive activities aimed at defending effective protection of production for a captive domestic market (Monge González and González Vega, 1995). All entrepreneurial energy must be devoted instead to create competitive advantages in appropriate market niches and to generate process, product, and service innovations that sustain a competitive edge (Beristain and Sánchez). This reallocation of valuable resources from directly unproductive activities to areas of comparative advantage has a powerful impact on income levels.

Openness discourages governments, in turn, from creating policy-induced distortions in the workings of the price mechanism. As Krueger (1978) argued, "a growth strategy oriented toward exports entails the development of policies that make markets and incentives function better, while an import-substitution strategy usually involves policies designed to frustrate individuals' maximizing behavior under market incentives" (p. 284).

Openness forces the authorities to protect macroeconomic stability, if the competitiveness of domestic firms in international markets is going to be preserved. Fiscal and monetary instability and healthy export growth are not compatible. For the same reason, real interest rates and real exchange rates cannot diverge much from their equilibrium levels. Inflation, which destroys opportunities for economic calculation, cannot be allowed. Similarly, domestic price regulations that hamper comparisons of relative profitability have to be dismantled.

Competitiveness also requires the authorities to provide the physical and institutional infrastructure required for exports. Ports and airports, roads, telecommunications, refrigerated storage and customs facilities must be upgraded. Legal systems need to be modernized and instruments for conflict resolution in international transactions provided. Without the critical provision of these public goods, the export drive encouraged by trade liberalization will not be as successful in increasing real per capita incomes. With increased openness, therefore, public sector actions will more likely focus on good domestic policies and the development of a productivity-enhancing infrastructure.

All of these are compelling (dynamic) reasons to seek freer trade, even when all the domestic conditions for Pareto optimality (in an static framework) are not present. They are particularly tenable in the case of small economies, such as those in Central America. They should constitute the most basic general guidelines about trade liberalization for Central American policymakers.

IV. Small Is Not Always Beautiful

In order to establish objectives for commercial policy decisions and evaluate alternative trade options for the Central American countries, it is also critical to understand the implications of being small. The Central American countries are too small, from several perspectives:

- (a) The Central American economies are small countries in the traditional sense of international trade theory; because they possess (individually or collectively) no market (monopoly or monopsony) power, they are price takers in world markets.

That is, by modifying their levels of desired imports or exports, these countries will not be able to improve their international terms-of-trade, which they must take as given.⁴ In some ways this may be a blessing. On the one hand, they need not worry about overproduction of exportables reducing their prices or underproduction of importables increasing them. On the other hand, they can concentrate their efforts in generating competitive advantages in particular market niches and in expanding their market shares, without worrying about price effects.

The immediate theoretical implication of being small price-taking countries is that, for them, the optimum tariff is a zero tariff. Equally true is that the optimum export tax, the optimum export subsidy, and the optimum import subsidy are all zero as well. It is important to keep this in mind when evaluating "protectionist" initiatives to promote exports, as have been the granting of certificates (*certificados de abono tributario*) as export incentives.

(b) The Central American countries possess (individually and collectively) domestic markets that are so small that this prevents them from securing the maximum productivity from available resources.

From a technological perspective, the domestic markets of the Central American countries are too small to allow for significant economies of scale or economies of scope in any production directed exclusively to those markets. By widening the potential market, international trade allows these countries to adopt modern technologies, exploit the economies of scale and of scope associated with them, and reduce costs of production to competitive levels.

⁴ In those case where some market power may exist (e.g., coffee, bananas), such power is already being exercised in other ways, so no optimum tariffs are needed to extract the potential monopoly rent.

From an organizational perspective, the domestic markets of the Central American countries allow for only limited specialization, division of labor, and competition. The competitive pressures exerted by imports, as trade is liberalized, prevent the emergence of welfare-reducing domestic monopolies, while access to the world market allows specialization that significantly reduces costs of production. These are powerful mechanisms to increase the productivity of resources in any economy.

- (c) Domestic markets are not only small, but in some of the Central American countries they are particularly fragmented.

In several of these economies, opportunities for arbitrage in markets for goods and factors of production are reduced by ethnic barriers and by the limited development of the physical and institutional infrastructure, leaving many opportunities for improved resource allocation unexploited. Such fragmentation accentuates the shortcomings of a small domestic market and calls for domestic market integration as a key challenge for policymakers. This objective demands an active presence of an effective state in providing the required public goods, a task that for a long time was neglected in Central America, for the sake of adopting interventionist policies to modify price and quantity formation, away from supply and demand, in many markets. Reform of the state in these countries should at the same time reduce the size of the public sector and strengthen the ability of governments to undertake these hard tasks (González-Vega, 1992).

- (d) The Central American economies are too small to allow for the efficient production of some non-tradable goods that are critical inputs in the production of tradables, thus increasing the costs of production of the latter. In general, if transaction costs in the domestic economy are too high, competitiveness will be reduced.

This problem is particularly acute when economies of scale are substantial, such as in the development of the physical infrastructure which, in turn, is so important for the reduction of transaction costs. This may be one of the strongest arguments for a process of integration of the Central American economies that focused on the development of a common physical and institutional infrastructure.

- (e) Narrow vectors of factor endowments leave these geographically small economies vulnerable to systemic shocks (e.g., natural catastrophes) and with limited opportunities for diversification.

Openness of the capital account, that allows for asset portfolio diversification, is indispensable to enable Central Americans more efficient risk management opportunities. Thus, the authorities must address liberalization of both the current and the capital account of the balance of payments as well as the macroeconomic complications that accompany international capital flows. When this is the case, additional constraints on fiscal and monetary policy are needed to protect macroeconomic stability. This is not an easy task.

- (f) The Central American countries possess small entrepreneurial teams to manage both private sector firms and public sector organizations.

The numbers of those with the training, skills, and experience to manage internationally competitive firms and/or design and implement a wide array of new policies, negotiate free trade agreements, and provide leadership to a new set of organizations are small. If such entrepreneurial abilities are the scarcest resource in these economies, special efforts must be spent to avoid any waste in their allocation. This feature (small teams) introduces critical constraints for the strategic choices available to the authorities.

In conclusion, given the shortcomings of such small economies and the expected dynamic contributions of trade to economic growth (which seem to dominate the static gains and losses under first and second-best scenarios), the only reasonable option for the Central American economies appears to be acceptance of the inevitability of a high degree of openness and integration into the world economy.

In the same way that small countries have to take world prices as given, the Central American economies must take something very close to free trade as given and, rather than resist this outcome, focus their energies on how to increase the competitiveness and flexibility of their economies, in order to obtain the best results from this unavoidable circumstance. It is from this perspective that they must evaluate their strategic policy options.

V. Human Resource Allocation to Policymaking

Powerful basic generalizations about the dynamic effects of trade on growth and welfare constitute the foundations for contemporary views on trade and development and suggest the direction of policy reform for the Central American countries. These concepts must be ceaselessly remembered during processes of policy design, implementation, and revision, in order not to allow inappropriate second-best(ism) to divert the efforts of the authorities away from these principles.

At the same time, however, such generalizations are not enough to guide the actions of policymakers, who must solve strategic questions about when, how, and at what speed to move from here to there. These strategic issues pose difficult questions to the authorities, for which economic theory offers at best much less clear answers. Resolving them would require the skills and efforts of some of the countries' best minds.

If, furthermore, the managerial teams available to design and implement commercial policies in the Central American countries are too small, decisions about how to allocate their efforts are critically important. These decisions are not easy, in any case, given increasing complexities of world trade arrangements and the uncertainties about future rules of the game. Events such as adoption of the NAFTA agreement, for example, further complicate the difficulties of designing appropriate commercial policy strategies for Central America. The efforts of the existing technocratic teams could be easily wasted if they had to design and implement a large number of policy options at the same time.

At the most basic level, the authorities have to choose how to spend time and effort in addressing two alternative ways to promote the beneficial dynamic effects from trade:

- (a) Efforts must be spent in revising commercial policies, in order to "get the prices right," so that economic agents face the appropriate incentives in choosing markets for their production and consumption activities.

In the presence of incorrect signals, the well-intentioned (private profit/utility maximizing) actions of economic agents will not lead to socially optimum resource allocations. To induce the appropriate signals, the Central American countries must design and implement policies that allow them to maximize the welfare gains from their insertion in the world economy. Trade policy reforms take time and effort.

- (b) Attention must be paid to improving an environment that allows economic agents, guided by correct price signals, to respond effectively by reallocating resources and by investing to take advantage of the new productive opportunities.

Efforts must be spent in accomplishing four complementary tasks for this purpose:

- (i) improving the institutional and regulatory framework that allows markets to function smoothly (legal systems that define property rights and provide mechanisms for contract design, courts for contract enforcement, grades and standards for trade, prudential regulation and supervision of financial institutions and the like);
- (ii) upgrading the physical infrastructure, in order to reduce transaction costs and facilitate international operations;
- (iii) further integrating the domestic market, in order not to create artificial distinctions between tradable and non-tradable goods and service; and
- (iv) maintaining macroeconomic stability.

All of these interventions would enhance competitiveness and would increase the elasticity of the supply of tradable goods in the economy. These tasks, however, are even harder to accomplish than revisions of commercial policy (despite the usual political economy complications) and do require a supply of managers and skilled personnel to solve the technical and administrative questions that emerge. In general, they require an ability of the state apparatus to accomplish tasks in a timely and cost-effective manner.

VI. Five Strategic Options

In their attempts to modify the nature and extent of their insertion in the international economy, the Central American countries face a number of strategic options that they may pursue either as a single or as a set of complementary approaches. These options include, at least, the following:

- (a) A unilateral movement towards freer trade, through the additional removal by each country of existing tariff and non-tariff barriers to trade with the rest of the world.

- (b) A concerted movement towards freer trade within the Central American region, in order to improve the operation of the Central American Common Market (CACM) as a free trade area, in recognition of the implications of geographical proximity and the historical roots of the integration process (i.e., some form of open sub-regionalism). This may be complemented with policy actions to reduce the transaction costs of trade throughout the region, in order to integrate it as a single market.
- (c) Consolidation of the CACM as a subregional entity, not *per se* but as a required step toward negotiations of accession to larger markets. These may include free trade agreements with Mexico, the United States, NAFTA, and/or other existing or future trade arrangements in the hemisphere (Group of Three, Andean Group).
- (d) Efforts to independently pursue bilateral free trade agreements with specific countries (e.g., Costa Rica with Mexico).
- (e) Actions to demand, individually or collectively, the continuation of preferential access to the United States market, through mechanisms such as an enhanced CBI, and battles for improved access to other major markets (e.g., bananas and the European Union).

VII. Costs and Benefits of a Strategy Choice

Given the number of strategic options faced by the Central American countries and the limited time and resources available to their small trade-policy management teams, it would be difficult, if not impossible, for them to pursue all of these possible alternatives and/or to move along a number of parallel avenues. Potential contradictions may even render such a broad-based approach inappropriate. The key strategic question then becomes how to choose among alternative policy options.

This is a typical exercise in strategic planning. At the simplest level, it requires a clear identification of the objectives (goals pursued) and a determination of the expected costs and benefits of each option. Given the complexity of the options (including all of the measurement and forecasting issues raised above), even this is not an easy task. Once such costs and benefits are identified, decisions must be made, constrained by the scarce managerial resources available.

At the more general level, the costs (and benefits) of each strategic option include at least the following:

(a) Resource allocation costs:

These represent all (long-term) impacts of each alternative policy option on the efficiency of resource allocation (aggregate welfare) in the economy, including:

- (i) the traditional static costs and gains from shifts in policy regimes (Harberger triangles);
- (ii) the dynamic consequences of different degrees of openness; and
- (iii) those costs associated with directly unproductive profit seeking activities (DUP) and other wasteful uses of resources induced by the policy regime chosen;
- (iv) environmental costs.

Measurement of these costs and benefits can become quite difficult if various policy regimes coexist and keeping track of them would be almost impossible if different policy regimes are adopted sequentially, modifying relevant elasticities in the process.

(b) Adjustment costs:

These represent all (short-term) costs of adjustment of production structures and consumption patterns to changing market signals, including:

- (i) the costs of shifts in investment patterns (as the relative profitability of investment opportunities is modified by the policy regimes), including the costs of irreversible investments and sudden obsolescence;
- (ii) the costs of shifts in employment opportunities, with all the economic and human losses from (even temporary) unemployment and labor force reallocations; and
- (iii) the additional (fiscal) costs of multiple compensations (if any) to sectors negatively affected by the policy shifts.

(c) Political costs:

Commercial policy shifts typically induce redistributions of purchasing power among sectors of the population that are significantly larger than resource reallocation effects on aggregate welfare (Rodrik, 1992). While the traditional static changes in welfare from trade policy revisions are typically estimated to represent one or two percent of the GDP, the accompanying redistributions of income may represent 10 to 20 percent of the GDP (Monge González and González Vega, 1995). The political costs of such redistributions are very high. Such costs would multiply with the sequential pursuit of several of the policy options listed above.

(d) Transaction costs:

Policy revisions represent additional transaction costs both for the public sector teams managing commercial policies and the private sector firms that have to adjust to the new rules of the game. Because of the comparative scarcity of entrepreneurial talent, there is every reason to economize and avoid unnecessarily duplicate uses of these valuable resources.

VIII. Basic Strategic Guidelines

Given the potentially high costs of frequent policy shifts and/or the simultaneous pursuit of numerous commercial policy options, the authorities need some basic guidelines to direct their choices. This paper proposes five basic criteria in dealing with these decisions:

- (a) Criterion I: Attempt to secure access to as large a market as possible.

The key to the static and dynamic gains from trade is the impact of market size on mechanisms to increase the productivity of available resources. The larger the market, the more powerful the beneficial influence of these processes.

- (b) Criterion II: Move toward solutions that rely, as much as possible, on the country's long-term comparative advantages.

The goal is to maximize the purchasing power of the country's population (a proxy for maximum welfare), by allocating resources to the production of commodities and services that are highly valued in world markets. Intermediate solutions that negate comparative advantages impose high social costs.

- (c) Criterion III: Move as close to the final policy configuration as possible.

Each intermediate step is costly (from the perspective of adjustment, political, and transaction costs). Unnecessary steps must be avoided.

- (d) Criterion IV: Move as rapidly as possible.

Although some gradualism may appear to reduce (concave) adjustment costs as well as political costs, this is not frequently the case (González-Vega, 1989). The longer it takes to arrive at the final solution, on the other hand, the higher the resource allocation and transaction costs involved.

(e) Criterion V: Play with the strong.

Learning processes are more fruitful and preparedness is better achieved when undertaken with strong partners that share the same long-term vision rather than with weak partners that are reluctant to move ahead rapidly.

The strategic options faced by the Central American countries are evaluated in this paper in terms of their expected costs and benefits and in light of the guidelines discussed above.

IX. Unilateral Trade Liberalization

Two parallel processes have dominated world trade policies in the last decade. One has been the movement towards reductions in global protectionism associated with the successful multilateral negotiation of the Uruguay Round under the General Agreement on Tariffs and Trade (GATT) and the creation of the World Trade Organization (WTO). The other one has been the resurgence of preferential regional trade treaties, which represent a departure of the most favored nation principle, and may thus reduce world trade (Rajapatirana, 1994).

Independently of the volume of net trade created either by multilateral trade liberalization or free trade agreements, the world market continues to be the most attractive option for the Central American economies (criterion I). Increased openness toward the world market must represent, therefore, their most basic commercial policy goal. The strategic question is how to best approach the desired greater insertion of the Central American economies into world trade flows. This paper claims that the most effective way of achieving this objective is through unilateral trade liberalization. Moreover, unilateral trade liberalization facilitates (reduces the costs of) more limited trade agreements with other countries and is thus compatible with some of the other policy options faced by the Central American countries.

Further expansion of the Central American countries' international trade is constrained both by protectionism at home and abroad as well as by deficiencies in the countries' physical and institutional infrastructure. In particular, the protectionist strategy of import-substitution industrialization introduced well-known biases against exports and inefficiencies in resource allocation (violated criterion II). As a result, the Central American economies generated less purchasing power, at international prices, than would have been possible in the absence of such distortions. Domestic protectionism reduced economic welfare. Protectionism abroad (particularly in the United States and the European Union) reduced economic welfare in Central America as well.

The welfare of the Central American populations could be increased, therefore, through further reduction of protectionism both at home and abroad. These two processes need not be conditioned on each other, however. The welfare losses from domestic protectionism can be eliminated by unilateral trade liberalization. The welfare losses from foreign protectionism can be eliminated by the unilateral actions of the United States and the European Union (maybe as a result of political persuasion). Protectionism both at home and abroad may be (but will not inevitably be) reduced as a consequence of the negotiation of trade agreements.

With unilateral trade liberalization, the expected welfare improvement is certain, resulting from a better allocation of available resources. Such an improvement is also certain if foreign countries unilaterally undertake a reduction of their barriers to imports from the Central American countries (equivalent to an improvement in their international terms of trade). Because they may lead both to trade creation and trade diversion effects, trade agreements may not improve welfare, however (second-best principle).

The net effect of free trade agreements may still be beneficial if the accords provide access to a much larger market (e.g., the United States), which is already the source of low-cost imports for the country (small trade diversion effects). Such free trade agreements may also be desirable in second-best political economy scenarios in which opposition to unilateral liberalization is unsurmountable, but this is not the case because of the *quid pro quo* of the agreement. { cost

A most important reason for the priority given here to immediate unilateral trade liberalization is that the greatest expected welfare gains for the Central American countries are associated with the elimination of the anti-export bias of domestic protectionism. The implicit tax levied on exports by the protectionist import-substitution structure has been high in Central America, leading to important welfare losses.

Utilizing a general equilibrium framework, in the case of Costa Rica, Monge González and González Vega (1994) found that, in 1989, the implicit tax (net of the impact of export subsidies --CATs) meant that 66 percent of the level of the average tariff used to protect import substitution activities was transferred as a levy on exports. That year, protection increased the domestic price of imported commodities by 55 percent above their international price, but it increased the price of imported goods with respect to non-tradable goods by only 13 percent, while the price of exports declined by 25 percent with respect to non-tradables. That is, because of such protection, with the same (physical) amount of sales abroad, exporters received 25 percent less in terms of non-tradable goods than if such protection would not have existed. It was necessary to tax exports by 25 percent in order to offer 13 percent of true protection against imports. The implicit tax was 32 percent in the case of traditional exports (coffee, bananas, sugar, and beef) and 15 percent in the case of non-traditional exports (22 percent without the CATs).

Given their estimated elasticity of export supply for Costa Rica of 0.73, Monge González and González Vega (1994) found that domestic protection reduced this country's annual exports by 18.3 percent. This meant that the anti-export bias of protectionism had reduced Costa Rica's exports by U.S.\$ 304 million in 1989. On the other hand, these authors estimated that elimination of all tariff barriers to United States imports of textiles, apparel, and leather goods from Costa Rica (20 percent of Costa Rica's exports to the United States) would have resulted in U.S.\$ 11.8 million of additional export earnings.⁵ While elimination of such protectionist measures against Costa Rican exports in the United States would be beneficial to this country, it appears that the gains from unilateral trade liberalization would be more substantial.

Moreover, domestic protectionism reduces welfare not only because of the induced misallocation of resources but also because of wasteful directly unproductive (DUP) activities, such as the use of resources in lobbying and other efforts to acquire and maintain protection (Bhagwati, 1982). The welfare losses associated with DUP activities are typically much larger than those represented by the traditional Harberger triangles. Monge González and González Vega (1995) found traditional estimates of the welfare losses from Costa Rican protectionism in 1989 to be equivalent to 0.9 percent of the GDP, commensurate with similar measurements in other countries. On the other hand, they estimated the upper bound to the welfare losses due to DUP activities at 20.3 percent of GDP. If unilateral trade liberalization reduced the extent of DUP activities, its impact on welfare could be very large.

⁵ Non-tariff barriers were not taken into account because quotas on imports of these goods had not been binding for Costa Rica. These estimates do not take into account, either, potential losses from trade diversion in the case of a trade agreement, which are not present in the case of unilateral liberalization.

In recent years, the Central American countries have drastically reduced tariff and non-tariff barriers to imports from the rest of the world (Lizano, 1994). From levels around 80 percent for the CACM common external tariff on imports of final goods a few years ago, by 1993 the tariff ceiling had been lowered to 20 percent, while tariffs on inputs and intermediate and capital goods reached 5 percent (with many imports benefiting from duty free status). Recent initiatives will move tariff levels to the 15-1 percent range. This process of unilateral trade liberalization has already born its fruits. The implicit levels of effective protection continue to be high and dispersed, however, and additional gains could be obtained from additional tariff reductions.

Unilateral trade liberalization has been accompanied by accession to the GATT (by Costa Rica in 1989 and the other countries after 1991). While the Central American countries can play a small role in promoting multilateralism in this forum and in the new World Trade Organization, their potential impact there is very limited (being such small countries, they are essentially free riders in worldwide process of liberalization). The most important impact of such participation is the discipline (principally through the most favored nation principle) that results from membership, which bolsters unilateral liberalization (Alam and Rajapatirana, 1993).

In a second-best scenario, a most important role of continued unilateral trade liberalization in Central America is a reduction in the threat from trade diversion that may accompany participation in several bilateral free trade agreements as well as in the CACM. The lower the effective rate of protection of domestic production, the less the probability that trade will be diverted away from cheap sources of supply toward less cost-effective partners in the free trade area or customs union (criterion II).

X. A Central American Free Trade Area Plus

The welfare-improving impact of a Central American country's unilateral trade liberalization can be complemented with the additional welfare gains from the reduction of barriers to imports by its trade partners' (e.g., other Central American countries, the United States) and the associated expansion of its exports. When such liberalization is not unilaterally undertaken by its trade partners, it can be achieved through a free trade area (FTA) agreement, which can serve as an strategic instrument to induce the reduction of barriers to trade by other countries.

The distinction in the removal of barriers to trade between FTA members and the rest of the world creates a second-best scenario, however, introducing the potential for welfare-reducing trade diversion effects (Viner, 1950). Preferential FTAs are departures from the most favored nation principle (first best), in that they bestow access to each member's market that is not automatically granted to all other countries. Trade is diverted from outside to inside the region and welfare is reduced. Some claim, however, that it is "nearly impossible to determine definitely and precisely whether trade creation or trade diversion predominates as a result of the establishment of any particular regional trade agreement" (Steinberg, 1993, p. 322).

While participation in any FTA is a decision not to be taken lightly, efforts to strengthen the CACM as a well-functioning free trade area seem to be a natural policy choice for the Central American countries. Since there are always prospects for trade diversion in forming regional free trade areas and the benefits and costs of joining cannot be clearly and easily established *a priori*, an important dimension of any strategic choice for the Central American countries in this connection would be to consider mechanisms to minimize the risks from participation in the new CACM (Rajapatirana, 1994).

The most important line of defense against welfare-reducing trade diversion effects is to insist on low protection against imports from the rest of the world in the first place. This will reduce the potential for trade diversion, because the profitability of substituting for imports from low-cost sources outside the CACM would be low (criterion II). This guideline highlights the importance of (individual or collective) unilateral trade liberalization. Institutional regional mechanisms must be created that continue the push toward the unilateral reduction of barriers to trade with the rest of the world, such that participation in the CACM becomes an instrument (building block) for further liberalization and not an obstacle (stumbling block) for it.

Moreover, while member countries should have the lowest possible tariffs for imports from the rest of the world (with tariffs being the only form of protection), attempts must also be made to increase competition within the region, for instance by removing existing domestic regulations that might limit such competition. In particular, harmonization of tax rules and of corporate regulations would permit keener competition across frontiers and in non-tradable sectors.

In general, the development of an institutional infrastructure that allows for lower transaction costs would permit further integration of each country's domestic market as well as of the regional market, lessening the negative impact of fragmentation on productivity. The transaction costs incurred in regional trade and factor movements can be further reduced, as well, by the development of the physical infrastructure. Regional projects that generate economies of scale and of scope in areas such as transportation, (electric) energy, telecommunications and the like are natural candidates for specific initiatives for cooperation. Joint research, technological transfer, and training programs as well as development of financial systems are also promising.

Macroeconomic policy coordination becomes important, furthermore, if competitive forces are to be mobilized to induce a better allocation of resources within the regional market. At the same time, although a common external tariff is desirable, because it vitiates the need to have rules of origin and the need for a (discretionary) bureaucracy to administer them, its adoption would be justified only within an institutionalized mechanism for continued unilateral trade liberalization. There does not seem to exist, for this process, an inexorable pattern that would replicate the path followed by the European Union (Rajapatirana, 1994).

To participate in the CACM and under what terms and conditions constitutes, therefore, an important and difficult strategic choice for the Central American countries, particularly given mixed feelings about the past performance of the proposed customs union. Since its inception, the CACM was expected to be an instrument to promote these countries' economic growth and modernization. In effect, in order to deepen their process of import-substitution industrialization, given their small domestic markets, the Central American countries tried to reach economies of scale through the preferential opening of their markets to the regional members.

In those earlier days, the CACM unfortunately incorporated a protectionist approach embedded in high levels of effective protection of production for the domestic market, discriminatory practices, and complex regulations. Regional integration simply replicated each country's distorted inward-oriented policies. Because it provided almost across-the-board free trade among its members, however, the CACM was comparatively "successful" in expanding intra-regional trade in the 1960s and early 1970s, but its internal contradictions, coupled with unmanageable external shocks, led to the disintegration of the common market in the early 1980s.

In the mid-1980s, in response to the region's financial and economic crisis, the Central American countries began the liberalization of their commercial policies, adopting more outward-looking strategies of development, coupled with economic stabilization and the privatization of public enterprises. Thus, recent efforts to revitalize the CACM have acknowledged the need to protect the international competitiveness of domestic firms and have taken place within a context of export promotion (Salazar Xirinach, 1994). This approach has reflected the worldwide characteristic of the new wave of regionalism "based on open trade compared to the first regionalization based on protection" (Bhagwati, 1992, p. 542).

Gert Rosenthal (1993) has also insisted in the concept that the ideal of a multilaterally open world economy, without artificial barriers to free trade in goods and services, does not exclude the gains from integration efforts. Moreover, such endeavors may actually contribute to the ultimate free trade goal. In his view, given the extent of reciprocal trade in Central America, similarity of productive structures, and geographical proximity, the formation of a free trade area must be complemented with a common external tariff, in order to discourage smuggling and to avoid unnecessary distortions in resource allocation. Similarly important is the coordination of macroeconomic policies, as sharp disparities in real exchange rates, real interest rates, and domestic rates of taxation have consequences similar to those of different tariff rates.

There are strong historical reasons for open regionalism and for the strengthening of a free trade area to be a natural policy choice in Central America. Difficult strategic questions arise, however, in determining how ambitious the integration scheme should be beyond the free trade area and how many of their scarce managerial resources (trade policy teams) should the countries devote to regional processes and institution building.

On the one hand, there are reasons not to overemphasize the deepening of the CACM. Not only are the Central American economies too small (violating criterion I), but they are not necessarily "natural" trading partners. Rather, from the perspective of their very similar productive structures, they are more like clones of each other (with limited opportunities for profitable trade in the absence of some protection, thus violating criterion II).⁶ Indeed, there may be too few goods for which another member of the CACM is the lowest-cost external source of supply for any one of them. These are precisely the reasons why the CACM was so attractive in the past as a protectionist tool. With full unilateral liberalization it could become irrelevant.

On the other hand, geographical proximity and a common history may induce low transaction costs, that may create localized opportunities to trade. This is clearly the case between Guatemala, El Salvador, and Honduras. The question is: will high volumes of efficient intra-regional trade survive a substantial lowering of protection through unilateral liberalization? The optimistic expectation is that such geographical (and other dimensions) of proximity will lower costs sufficiently for the regional trade to continue to be an attractive opportunity in obtaining the gains from trade for these countries. There are no clear answers to this empirical question. Specific investment in the physical and institutional infrastructure that would make this continued trade possible is an attractive option, but it must be subject to rigorous cost-benefit analysis.

While the list of products not subject to free trade in Central America is short, non-tariff barriers to trade have proliferated (Monge González, 1995). Strategic actions should focus on the elimination of these obstacles and extension of the free trade status to services.

⁶ Customs unions tend to be more beneficial when they are created by members with different productive structures, thus allowing for complementarities.

XI. Going After the Key United States Market

The United States continues to be the largest single trading partner for the Central American countries. About two-fifths of Central American exports are sold in the United States and over 45 percent of imports come from this country. On the basis of criterion I, therefore, Central American policymakers should pay particular attention to improving access to the U.S. market and should target it as a main locus of their concerns.

Preferential access to the U.S. market had been provided in the past by the Caribbean Basin Initiative. Some see this mechanism as most desirable, as access to the U.S. market is not conditioned on similar degrees of access to the Central American markets for U.S. products (asymmetric trade barriers). Given the strong arguments for unilateral trade liberalization presented in this paper, however, such asymmetry is not necessarily critical. What ultimately matters is the reduction of U.S. barriers to imports from the Central American countries, equivalent to an improvement of their international terms of trade.

Negotiation of NAFTA eroded the comparative gains from preferential CBI access vis-a-vis Mexican competitors. Some efforts may be spent in lobbying the U.S. Congress for the approval of the Crane bill and equivalent unilateral measures that would guarantee CBI countries treatment similar to that accorded to Mexico. In the long-term this is not a satisfactory arrangement, however, given the political vulnerability of the annual congressional approval required. Even if continuation were to be expected, this transitory system does not offer sufficient certainty to investors interested in exports to the U.S. market (Lizano, 1994). Rather than insisting on its continuation, the Central American countries should focus their attention on preparing for the Free Trade Area for the Americas announced in Miami.

XII. The Multiplication of Free Trade Agreements

In recent years, Latin America has seen a virtual proliferation of free trade agreements, ranging from the resurrection of the Andean Group, with the establishment of a free trade zone starting in 1992, to the formation of Mercosur (Argentina, Uruguay, Paraguay, and Brazil) in 1991, the Group of Three (Colombia, Venezuela, and Mexico), and NAFTA as well as bilateral agreements, such as those between Mexico with Chile and with Bolivia. The Central American countries have not been immune to this process. Costa Rica signed a bilateral agreement with Mexico, to be followed by the other countries.

This multiplication of bilateral and trilateral free trade agreements poses difficult strategic questions to Central American policymakers. On the one hand, there are costs of being left behind, if all other countries are participating in them. On the other hand, numerous free trade agreements impose high costs to the countries involved (as this strategy violates most of the criteria adopted in this paper for an efficient movement towards freer trade).

In order to minimize costs of the transition, it is desirable to move as close to the configuration of the final preferred solution as rapidly as possible (criterion III). Each intermediate step is costly from several perspectives. In terms of resource allocation efficiency, the trade diversion effects of violations of the most favored nation principle reduce the country's welfare. In terms of adjustment costs, the structure of effective protection associated with each intermediate step redirects resources to new uses, only in a transitory manner. This is particularly costly if investment is not reversible and if there is not perfect mobility of factors of production. The numerous political negotiations required waste valuable resources in directly unproductive activity and provide opportunities for protectionist views to influence the arrangements made.

Individual negotiations of bilateral free trade agreements represent substantial (transaction) costs to the small commercial policy teams of the Central American countries and may actually induce delays in the process of reaching free trade status (violating criterion IV). Moreover, it is difficult to imagine that such arrangements with weak partners would be suitable loci for the learning processes and increased preparedness that are required to fully participate in more wide-ranging trade agreements, such as NAFTA (thus contradicting criterion V).

The *Protocolo de Guatemala*, approved in October, 1993 to update and modernize the *Tratado General de Integración Económica*, is a very general legal instrument which does not define clear strategies for the process of trade liberalization in the region. As a result, commitment to a common external tariff has not been honored. The formation of the customs union is incompatible, in particular, with the bilateral negotiation of FTAs with members from outside the CACM (Salazar Xirinachs, 1994). If indeed there is no commitment to the joint negotiations required by the customs union, perhaps the authorities should concentrate their efforts in improving a free trade area for Central America and adopt well-defined rules of origin.

The greatest danger for Central America would be a fragmentation of the Western hemisphere into a small number of subregions, one of them the CACM next to other larger groups, such as NAFTA, Mercosur, and the Andean Group. Even together, the Central American countries constitute a very small market, much smaller than any of the economic spaces covered by the other FTAs. While firms in the other trade blocks would be able to lower their cost curves by reaching economies of scale and taking advantage of greater degrees of specialization and division of labor, the small CACM would have clear disadvantages in this dynamic framework.

Such a fragmented hemisphere, diverting trade away from Central America toward the members of each FTA, while keeping enough degrees of protection to maintain Central American products out, would be the worst of all worlds for Central American policymakers. This is one of the dangers, however, of emphasizing strengthening of the CACM, even if only as a vehicle to gain access to larger free trade areas. This may be inevitable, nevertheless, given the reluctance of potential partners (in particular the United States) to negotiate individually with each country, given the high transaction and political costs involved.

XIII. The Road Ahead

This paper has attempted to assess alternative commercial policy options for the Central American countries, while taking into account the constraints and uncertainties faced by policymakers in a rapidly changing economic and political environment. In particular, among key recent changes in their external environment, the creation of NAFTA introduced both new threats and new hopes for the Central American countries. On the one hand, it occasioned instances of trade diversion and investment diversion away from Central America. On the other hand, it was seen as a first step toward the formation of a hemispheric free trade area. It bolstered, in any case, the political strength of trade liberalizing circles in Central America.

As a consequence of these events, however, the Central American countries now face a more difficult set of policy options. This is due, in part, to the proliferation of second-best situations, given the ^{variety} variegation of trade regimes that prevail, with their multiple divergences from the most favored nation principle. It is due, in addition, to increased uncertainties about the future rules of the game and about the intermediate steps required before hemispheric free trade actually prevails.

Given the overwhelming importance of the dynamic benefits from free trade, there is no doubt about the desired general direction of policy reforms and infrastructure building, even in the presence of domestic distortions. The Central American countries are so small, for every economically relevant meaning of the term, that they must basically take free trade as given, as an inevitable facet of their initial conditions. They must focus, in turn, their energies on increasing their competitiveness and the flexibility of their economies. They must resolve, in addition, questions about how to strategically proceed in their trade liberalization efforts.

The design and implementation of new commercial policies, the management of internationally competitive firms, the construction of physical and institutional infrastructures to facilitate trade, and the quest for macroeconomic stability require capable and experienced managerial teams, both in the private and the public sector. Because these teams are small in the Central American countries, the allocation of their efforts to the development and implementation of alternative commercial policy options requires some economizing.

Given the resource allocation, adjustment, political, and transaction costs of alternative policy options, the authorities need guidelines to make choices about the allocation of their scarce time and capabilities. This paper offers five basic strategic guidelines to direct them in their efforts, namely:

- (a) Secure access to as large a market as possible.
- (b) Rely, as much as possible, on the country's long-term comparative advantages.
- (c) Move as close to the expected final policy configuration as possible.
- (d) Move to the final solution as rapidly as possible.
- (e) Join strong rather than weak partners.

More than any other option, unilateral trade liberalization fulfills these basic guidelines. It targets the world market, while it reduces the costs (in terms of trade diversion) of some more limited approaches to free trade, such as participation in free trade areas. By eliminating biases against exports, unilateral trade liberalization is welfare improving *per se*, and it does not require complex international negotiations. Because any change in commercial policies always carries important redistributive consequences, however, unilateral trade liberalization may be difficult in a political environment dominated by protectionist lobbies.

Since the mid-1980s, in response to the region's economic crisis, the Central American countries have rapidly advanced their unilateral trade liberalization efforts, with dramatic increases in their exports outside the CACM. This process should continue, toward the achievement of an ideal 10 percent uniform tariff, and it should encompass services and not just commodities. Clearly, all non-tariff barriers to trade must be eliminated, while the process of opening the capital account of the balance of payments must be completed. This process would take place within the framework of the World Trade Organization.

Despite the potential threat of trade diversion, strengthening of the CACM as a free trade area seems to be a natural step for the Central American countries as well, given their geographical proximity and common historical roots. The threat of trade diversion can be minimized, moreover, by adopting low levels of protection against imports from the rest of the world, in the first place. Development of a physical and institutional infrastructure that reduces transaction costs in regional trade would increase "natural" opportunities for trading and would thus eliminate opportunities for trade diversion as well.

Recent efforts to revitalize the CACM, from the perspective of an "open regionalism," have attempted to strengthen the implicit free trade area. The consolidation of free trade in the region, including agricultural commodities and (financial and non-financial) services, should be accomplished. Similarly important is the development of more efficient payments mechanisms, including the operations of the *Fondo Centroamericano de Estabilización Monetaria*. Competition must be promoted by removing existing repressive domestic regulations and through the harmonization of tax rules. Regional infrastructure projects will contribute to a reduction of transaction costs.

The strategic choices become more complicated if the purpose is to transform the CACM from a free trade area into a customs union or a deeper type of integration which included coordination of macroeconomic policies. Although there may be clear advantages from coordination, there are no clear answers about how to proceed when not all the countries want to move in the same direction and at the same speed. The situation is further complicated by the recent proliferation of bilateral free trade agreements which, in some instances, contradict the rules of the CACM as a customs union. If the national managerial teams have their hands full, there should be limits to how much to devote their efforts to the (small) Central American market. Their main task should be to get the country "ready" to participate in the more broad hemispheric free trade arrangements of the future.

Multiple negotiations of bilateral free trade agreements is clearly a suboptimal strategy, while not much hope must be placed in the continuation of preferential arrangements such as the CBI. The proliferation of free trade agreements that violate the most favored nation principle not only create complex second-best scenarios, but impose high adjustment and transaction costs.

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