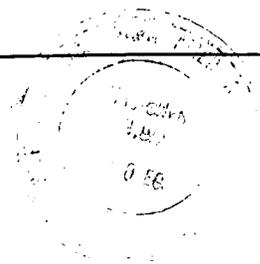


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## **Is a Genuine Partnership Possible in a Western Hemisphere Free Trade Area? Some General Comments**

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UNITED NATIONS ECONOMIC COMMISSION FOR LATIN AMERICA  
AND THE CARIBBEAN



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Is a Genuine Partnership Possible  
in a Western Hemisphere Free Trade Area?  
Some general comments

H W Singer<sup>1</sup>

**(1) FREE TRADE AREAS AND THE GATT**

**(a) Trade creation and trade diversion: netting out costs and benefits**

The chief debate surrounding free trade areas and regional trade blocs which has dominated the general literature on the subject is that of trade creation versus trade diversion. Regional blocs can lead to trade creation, partly by increasing trade within the bloc and partly by increasing overall incomes and productivity within the bloc and hence leading to additional demand for imports, including imports from countries outside the bloc. They can also lead to trade diversion, partly by reducing imports by countries within the bloc from countries outside the bloc, and partly by diverting the resources of countries within the bloc away from exports to countries outside.

Trade creation is welfare-increasing because it shifts production from less efficient to the most efficient producers within the Free Trade Area. It may also, by providing larger markets for producers bring increasing returns and new dynamic comparative advantages into operation. This growth-oriented rather than allocation-oriented aspect of a WHFTA would be of special importance to Latin American and Caribbean (henceforth LAC) countries. Trade diversion is welfare-reducing because it shifts production from efficient producers outside the FTA to less efficient producers within the FTA. Given this dual potential effect it is difficult to be categorical or a priori confident as to whether FTAs increase or diminish welfare. Everything depends on the detailed arrangements within the FTA and on its policies and degree of openness towards outsiders.

**(b) FTAs and Multilateralism**

This whole debate of whether trade creation will be dominant over trade diversion or vice versa is linked (although not always clearly) with the description of regional blocs as being either "stepping stones" to global trade liberalization and trade expansion, or else becoming "fortresses" and thus acting as stumbling blocks and obstacles to multilateral liberalization. This will depend partly on how the FTA is designed - in particular whether it strictly complies with the GATT rule under Article XXIV that tariffs and other trade barriers against outsiders should

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<sup>1</sup> Research assistance from Nicholas Georgiadas is gratefully acknowledged.

not be increased and that the agreement must apply to "substantially all" intra-partner trade - and partly whether its formation takes place in an international climate of progress towards multilateral liberalization or whether it is adopted in response to breakdowns and frictions frustrating the pursuit of multilateral negotiations.

Given that, at the time of writing, the WHFTA proposal is pursued at a time of great uncertainty and lack of progress in the multilateral liberalization aimed at in the Uruguay Round, the GATT is clearly worried about potential trade diversion/stumbling block aspects of WHFTA as indicated in its very recent review of US trade policy. The GATT cites illiberal and protectionist features and tendencies in US trade policy (especially in anti-dumping action and countervailing duties and generally unilateral action under Section 301) which it fears are indicators that WHFTA might be an instrument of trade diversion and undermine the Most Favored Nation principle. On its part, the US has reaffirmed its commitment to a strengthened multilateral trading system, and clearly wishes the WHFTA to be considered as a stepping stone towards such a system and an instrument of trade creation. Article XXIV of GATT which permits full free trade areas with 100% free trade within the area (although not partial regional preferences - the logic of this is not entirely clear) is based on the latter assumption, ie that the free trade area is in the context of a movement towards a world of global multilateralism as represented by GATT.

The trade diversion effect will be specially important where there are structural or natural limitations on overall supply of export goods, e.g. in the case of energy or other natural resources. Trade diversion, by reducing incomes of countries outside, can then lead to trade reduction or trade destruction. This danger is strongly reinforced if WHFTA provides incentives (or excuses) for Asian and European countries, and their regional groupings, to adopt restrictive trade and investment policies. This illustrates the importance of keeping WHFTA GATT-compatible, and making the negotiations transparent to trading countries outside the WHFTA.

(c) Pros and Cons for Latin America

From the point of view of LAC countries, the relationship between WHFTA and the Uruguay Round, is ambivalent. Multilateral trade liberalization will dilute the benefits of WHFTA for LAC (and also for North American exporters to Latin America). On the other hand, multilateral liberalization will help LAC exporters in third markets, and they will also benefit from a general trade expansion and rise in incomes. Here is another difficult "netting out" of pros and cons to be done, and the net result might well be different for different countries. However, there is no real problem for decision making since the success or failure of the Uruguay Round is more or less a datum for LAC countries, beyond their reach of influence. A scenario of no Uruguay Round/no WHFTA would be worse for Latin America than either Uruguay/no WHFTA or WHFTA/no Uruguay.

From the Latin American point of view, the chief attraction of WHFTA would be that it prevents the negative consequences of the marginalization which would result if the three big

regional blocs in North America, Europe (including Eastern Europe and continued preferential treatment of Lome countries), and Japan (with the NICs and coming NICs in East and South East Asia) should materialize and frustrate the process of global liberalization. This would be a very dangerous and unfavorable situation for Latin America (except perhaps for Mexico which, if NAFTA is ratified, will be included in the North American bloc). If such marginalization were to be combined with continued slow growth in the world economy, growing protectionism, continued debt pressure and unfavorable terms of trade, the outlook would be gloomy indeed. By contrast the WHFTA would appear in a good light, offering an escape from such a gloomy scenario. Even so it would still be a second best, with full multilateral global trade liberalization under GATT a first best - if that were a realistic alternative.

## **(2) DIFFICULTIES IN PREDICTING THE OUTCOME OF WHFTA**

### **(a) Calculating Dynamic Comparative Advantage**

The problem of netting out the positive effects of trade creation and the negative effects of trade diversion is not the only reason why it is so difficult to be certain about the ultimate impact of WHFTA. One other reason relates to the fact that the trade creation based on existing static comparative advantages is only one part of the hoped-for benefits from a free trade area. The advocates of a FTA expect as much or more from the increase in efficiency of production and the development of new dynamic comparative advantages which trade creation is expected to bring in its wake, resulting from longer production runs, increased specialization, investment in specialized machinery etc and the associated benefits of transfer technology and increased investment under the enterprise America Initiative (EAI).

Such dynamic advantages are impossible to quantify numerically in any model and difficult to predict. (The same is of course also true of the dynamic disadvantages and vicious circles which might follow in the wake of the harmful effects of trade diversion or marginalisation.) Estimates of dynamic gains have been made in connection with NAFTA, but their applicability to WHFTA is limited by the fact that the dynamic gains to Mexico arise partly from the displacement of other Latin American exports which would not apply under WHFTA. These dynamic comparative advantages are the most important for sustainable development. They are largely man-made rather than natural. Thus it is crucially important that LAC countries should not just passively accept the opportunities arising from location or natural resources, but should actively use the restructuring inevitably connected with a WHFTA to create new dynamic man-made advantages, as Japan and Korea have done. This will require active trade, industrial, educational, training and technology policies with careful selection and concentration on priority sectors. Such policies can and should be market-friendly, but they involve more than blind reliance on the market forces of the day.

### **(b) A Mega-project**

The second reason why the ultimate effects of WHFTA are difficult to foresee is that it is a mega-project: economic reasoning and modelling are better adapted to dealing with relatively small marginal changes in circumstances rather than revolutionary upheavals such as WHFTA, given both its large scale and also the fact that it is itself a part of a trade/investment/debt-reduction package (EAI). What we are talking about in the case of WHFTA is not really trade creation, but rather development creation.

### (c) Calculating Welfare Effects of WHFTA

The 'welfare-increasing' and 'welfare-reducing' effects of WHFTA must also be carefully defined. The WHFTA could be welfare-reducing for the countries outside but welfare-increasing for the Western Hemisphere. It could be welfare-increasing for some parts of the Hemisphere but welfare-reducing for other parts, welfare-increasing for some sectors but welfare-reducing for others, welfare-increasing for, say, large-scale modern producers within a sector but welfare-reducing for other, say small-scale, producers etc. There will always be gainers and losers. Theoretically the net effect can be measured by compensating the losers (Pareto optimum). But such compensation arrangements are politically difficult to negotiate, and the very compensation process may set welfare-reducing forces in motion.

If the WHFTA becomes a 'fortress' the effects could be welfare-reducing in the long run, even in the absence of retaliation from Europe or Japan. The difficulty of predicting overall net effects is heightened by different assumptions about what the alternatives to WHFTA are. Is it the present status quo? Is it a success of the Uruguay Round with progressive multilateral liberalization? Is it strengthened or weakened regional cooperation within Latin America? To what extent will Japanese and Western European investment flows be diverted to Eastern Europe and the Commonwealth of Independent States (former USSR)? Will domestic opposition among more immediate losers, both in North and South America, be overcome in welfare-efficient ways or will it lead to distorting exemptions and injury clauses or embittering trade disputes? While different assumptions can be built into models constructed to forecast the impact of WHFTA, no model can correctly produce the actual future mix of economic and political circumstances which will determine the outcome. Even at a future date we can never be sure: what would the situation of LAC countries have been in the absence of a WHFTA, or with a differently constructed WHFTA? Such counterfactual evidence is notoriously near-impossible and leaves the field wide open to subjective judgements. Thus, if the WHFTA is designed as a counter to possible West/East European or Japan/East Asian integration plans any analysis would have to be based on a double counterfactual speculation, namely (i) what would be the impact on the Western Hemisphere of any such European or East Asian integration; and (ii) what would be the impact of WHFTA in an assumed world of European and/or East Asian integration? (The "and/or" in the preceding sentence in fact indicates the possibility of not one, but three, counterfactual situations with which Western Hemisphere countries could be faced.) Could the WHFTA provoke the very European and/or Asian bloc integration against which it would be designed as a defensive measure? Will the existing preferential agreements with

non-hemispheric countries, under the GSP or otherwise, be maintained or modified while the WHFTA is established? Would the alternative be increased US protectionism? Will the FTA be accompanied by increased aid or investment? The number of possible scenarios is large and each change in scenario would make a great difference to its impact on the Latin American partners.

(d) Who will seize the opportunities?

The issue of trade efficiency adds to the difficulties of predicting the impact of WHFTA with any degree of confidence. It means that it is not just a question of analyzing or visualizing the new opportunities which may open up to different LAC countries in the North American market and try to assess their distribution among different LAC countries, it is also a question of the ability of different countries to seize the opportunities opening up to them. The latter is much more difficult to predict than the former. In the past, opportunities for manufactured exports were probably very similar for the East Asian tigers as for Latin America but the former proved to be better at seizing their opportunities (and to some extent pre-empting them).

### (3) THE SPECIAL NATURE OF WHFTA

(a) Theory and Practice: who benefits from FTAs?

The "genuine partnership" (or "broad-based partnership", as it is described in the letter to Congress introducing the Enterprise for the Americas Act) proclaimed by President Bush cannot of course be a partnership of economic equals. It is an Enterprise for the Americas, not for America!

In theory, free trade areas may benefit weaker countries as much or even more than the larger and richer partners ("the small country assumption"). This is supported by advocates of FTAs who put emphasis on the resulting economies of scale, leading to more rapid growth which would be particularly important for the relatively smaller and poorer countries. Poorer countries would tend to benefit as much or even more than the larger and richer partners as production would tend to move from high-cost regions to low-cost regions, contributing to an increase in the amount of capital and an increase in the level of wages in the low-cost regions. This would lead to relatively higher growth of the more backward countries, and thus to a convergence of income levels within the integration scheme.

However, this argument is founded on various simplifying assumptions including perfect competition, full employment, constant returns to scale, and perfect mobility of factors of production, which do not correspond with reality. In order to understand the nature of the problem one has to go beyond such simplifications and observe that there exist a number of factors which are likely to contribute to relatively less rapid growth (or even decline) of

relatively poorer countries in an integration arrangement. For example, capital may flow from poorer to richer areas, due to factors such as greater availability of economic infrastructure, access to specialized services, proximity to large markets, greater relative development of capital markets, greater institutional and administrative capability of a region.

Also, widening of markets (due to trade liberalization in an integration scheme) will often give competitive advantages to the industries in the more advanced regions. Under these conditions, initial differences in productivity and economic development can lead to "circular and cumulative causation" and thus growing polarization between the different members of an integration scheme; hence the creation and perpetuation of inequalities. That is what Hirschman calls "polarization" and Myrdal the "backwash" effect. The main idea that Myrdal and Hirschman convey is that the play of market forces normally tends to increase rather than decrease inequalities between regions in an integration arrangement. For instance, if a region is not attractive for investment, it will tend to enjoy less technological progress and benefit less from economies of scale than other regions; this in turn will make it even less attractive for foreign investment. Furthermore, in order to take advantage of the positive or "trickle down effects" of the wider market, a poor region must have developed its infrastructure, human capital and administrative and institutional capability to a level which will allow the region to benefit from the effective growth impulses transmitted from other prosperous regions.

Political reality adds another dimension to the issue. Regional arrangements have suffered, and sometimes fallen apart, because of dissatisfaction of weaker partners with a concentration, real or imagined, of the benefits of the integration going disproportionately to the better-off countries. In addition to real economic reasons for this - a better infrastructure of technology, skills, transport and existing industrial structure to take advantage of new trading opportunities and larger markets and withstand intensified competition from abroad - the stronger countries will also be more effective in negotiations to shape the FTA agreement so as to take account of their national interests and also in subsequent dispute settlements. Hence economic gaps or differentials between partners are relevant, in practice and in theory. It has been suggested that the stronger partner will use his superior bargaining strength and negotiating capacity to extract "side payments" on other related matters.<sup>2</sup>

(b) Unequal partners in WHFTA

(1) Labor productivity/per capita income

Labor productivity in manufacturing as measured by value added per worker in 1990 in

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<sup>2</sup> G K Helleiner, "Towards a New Regional Development Strategy for Latin America in the 1990's" note prepared for a panel discussion at the Inter-American Development Bank conference on **Latin American Thought: Past, Present, and Future** - Washington DC 14-15 November 1991.

Latin America was less than one third of that in North America. This is a greater differential than that between productivity in Western Europe as against Eastern Europe and the former USSR where the differential is a little over 2:1, but less than the differential between Japan on the one hand and East and South-East Asia on the other hand, which is closer to 4:1 than 3:1. It should be one of the objectives of WHFTA to reduce this 3:1 differential. The discrepancy in per capita income levels is even greater, of the order of 7:1.

The labor productivity differential of Latin America as against the North American level differs sharply between various sectors of manufacturing industry. Based on 1990 data from the UNIDO database, the overall differential is 3.3:1. The sectors which have a markedly more favorable differential - and which therefore should be in a good position to benefit from expanded trade opportunities under the WHFTA - include textiles, leather and fur products, petroleum refineries, miscellaneous petroleum and coal products, rubber products, iron and steel and non-ferrous metal products. By contrast, sectors where Latin American labor productivity is less than one fifth of the North American level include food products, tobacco products, wood and cork products, furniture and fixtures, various non-metallic mineral products, and non-electrical machinery. These are the sectors which prima facie would be expected to be adversely affected by WHFTA.

Without compensatory measures or a free flow of capital and labor, completely free trade between two areas with such productivity differentials could lead to a widening of the gap to the disadvantage of the weaker partner. Free flow of capital was in fact emphasized by President Bush, when he named investment as the third pillar of his proposal, together with trade and debt-reduction. (The vexed and explosive "hot potato" of free movement of labor was not touched.) It can of course be argued that the productivity differential between Latin America and North America is less important than actual progress in raising both manufacturing employment and labor productivity in Latin America. But equally it may be true that without some distribution of benefits favoring the poorer partner the WHFTA proposal may not be politically acceptable or sustainable in Latin America. Griffith-Jones, Stevens and Georgiadis argue that ancillary economic policies are necessary in WHFTA and propose a model of redistribution mechanisms based on the experience of the European Community<sup>3</sup>.

(2) Comparison with other potential blocs.

North America would also be the larger partner in terms of the volume of manufacturing employment (20 million as against 10 million). This is in sharp contrast both to the situation in Europe where manufacturing employment is in fact larger in Eastern Europe and USSR than in Western Europe, and also to the situation in East Asia where manufacturing employment in Japan is smaller than in East and South East Asia. Thus, as far as sheer weight of numbers is

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<sup>3</sup> See Griffith-Jones S., C. Stevens and N. Georgiadis, "Regional Trade Liberalization Schemes: The Experience of the EC", paper prepared for IADB/ECLAC, August 1992.

concerned, the importance of the advanced "core" in relation to the "periphery" is greater in the case of the WHFTA than in the two other potential blocs. This means that while the impact of WHFTA on North American employment and the US economy in particular may be small and submerged by other economic trends and events, the impact on the LAC economies would be major and thus has to be carefully analyzed and, as much as possible, anticipated.

### (3) Export Coverage

The unequal weight of the partners is also indicated by the fact that for the US the extension to the Free Trade Area from Canada to the rest of the Hemisphere is a relatively small step in terms of export coverage, even including Mexico, from 21.0% by an additional 13.5%; whereas for the LAC countries the extension from Latin American preferences to WHFTA is a very major step - overwhelmingly so for Mexico (from 7.6% by an additional 66.0%) and Venezuela (from 9.0% by an additional 56.6%, but even for Brazil from 12.9% by an additional 28.9%). From the point of view of the US, the big steps in regional integration have already been taken; from the point of view of LAC countries the big steps are still to come.

### (c) Country Diversity

Prima facie, one would expect that the impact of WHFTA on individual LAC countries would largely depend on the share of their exports to the US/Canada. This is highest for Mexico (66%), Venezuela (57%) and Ecuador (46%); considerable for Brazil (29%), Colombia (41%), Peru (32%); but low for Argentina (24%), Bolivia (17%), Chile (19%), Uruguay (12%) and virtually non-existent for Paraguay (4%). However, it would be a very static assumption to make that countries would benefit from WHFTA in the same order. On a different reading, a low share could be taken to indicate the existence of a large unused potential, thus reversing the order of benefit. Exports to non-hemispheric countries are over half of total exports for Argentina (65%), Brazil (58%), Chile (67%), Paraguay (54%) and Uruguay (61%); under half for Bolivia (25%), Colombia (43%), Ecuador (33%), Mexico (26%), Peru (49%) and Venezuela (34%). These figures would indicate the various degrees by which LAC countries could be affected by any "fortress" developments in WHFTA and possible retaliation by outside countries.

Imports from the US also form the highest share of total imports in Mexico (66%) and Venezuela (43%); range between 30-40% in Colombia and Ecuador; between 20-30% in Bolivia, Brazil, Chile and Peru; and are below 20% in Argentina, Paraguay and Uruguay. These figures indicate considerable variations in reliance on imports from the US. Dependence on imports from outside the Hemisphere is highest in Brazil (64%); between 40% and 50% in Argentina, Chile, Ecuador, Paraguay, Uruguay and Venezuela; between 30-40% in Bolivia, Colombia and Peru; and lowest (28%) in Mexico. By comparison, US hemispheric exports to Latin America were under 10% of total exports (although this figure jumps to 35% if Canada is included - comparable to the share of hemispheric exports by Argentina and Chile). Similarly

the share of US imports from Latin America is only 12%, and the hemispheric share, even with Canada included, at 29% is still lower than for any LAC country. Naturally, these aggregate figures only acquire real meaning for an assessment of the impact of WHFTA when broken down by categories of goods. This further analysis is beyond the scope of this paper.<sup>4</sup>

#### **(4) IS A GENUINE PARTNERSHIP POSSIBLE?**

##### **(a) Conditions to be met**

###### **(1) Strengthening of Trade Creation**

The trade creation effect would be strengthened by free flow of investment and removal or reduction of distorting external pressures like the perverse payments arising from debt servicing (both included in President Bush's EAI proposal), but also by improved transport and information links within the area, by freer movement of labor and stable and satisfactory terms of trade and commodity prices (none of them mentioned in the message by President Bush). Entirely free movement of labor is clearly not realistic politics; what is under debate is the extent of controls on the movement of labor (including brain drain). The ideal objective for both parties would be to reduce the incentive to migrate from South to North by providing productive employment and better incomes in the South, while liberalizing conditions of entry into the North as much as possible.

However, there seems to be a tendency to sweep this subject under the carpet by tacitly assuming that creation of employment in the South would have no impact on employment in the North. This is not the case. To some extent it is unavoidable that the increased employment and increased exports from the South will be at the expense of unskilled labor in certain industries and regions of the North. While the prospect is that the net effect on employment in the North will be beneficial, both through increased employment in technology-intensive and skill-intensive industries and as a result of a general expansion of trade and rise in incomes, there are bound to be losers among particular categories of workers and in particular industries. This will call for adjustment as well as good social and compensatory policies in the North to avoid popular and congressional hostility to a WHFTA agreement (even though such a protectionist backlash would be the worst possible response). The US Trade Adjustment Act now in place - but under threat of withdrawal - would have to be strengthened and effectively implemented. Such adjustment, often from manufacturing into service industries, on past experience might well result in lower wage scales for some groups of US workers - hence it alone may not be sufficient to eliminate domestic opposition. Many of the issues involved could

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<sup>4</sup> But see Refik Erzan and Alexander Yeats, "Free Trade Agreements with the United States - What's in it for Latin America?", World Bank, Policy Research Working Paper Series 827, January 1992.

have been mapped out in advance by the NAFTA agreement.

## (2) Terms of Trade

The question of terms of trade and commodity prices is particularly important to LAC countries in view of their frequent and recent experience of "immiserising trade expansion", ie expansion of export volume accompanied by falling or stagnant export revenue and/or real earned import capacity, as a result of falling prices and deteriorating terms of trade.<sup>5</sup> During 1985-1990, export volume expanded at an annual rate of 4.3%, but all these additional revenues were wiped out by deteriorating terms of trade and there was no increase in earned import capacity at all. This experience has not been limited to exports of primary commodities but has also extended to their trade in manufactures.<sup>6</sup> Trade expansion may be a rational objective in itself for the world as a whole and for both partners taken together, but for an individual trading country it is only a rational objective if it leads to additional earned import capacity. (There is a qualification to this statement: in so far as employment creation is an objective in itself, the expansion of the volume of trade is a good thing in itself - but there should be better ways of achieving this than immiserising trade.) Immiserising trade expansion will not help Latin America to cope with its debt crisis - clearly an important motivation behind the WHFTA proposal.

## (3) Improving Trade Efficiency

The experience of immiserising trade expansion in the 1980s points to a failure to compete abroad in terms of non-price factors such as product quality, marketing organization, supporting financial services, prompt delivery etc. If the WHFTA can help to improve the non-price efficiency of trading this would be not the least important benefit to LAC countries; technical assistance and other relevant support in this area would deserve high priority. Improved trade efficiency has in fact been put forward as a major argument in favor of an association of developing and industrial countries in a preferential or free trade area:

"As the markets of the industrialized countries are the key markets for the non-traditional exports of the developing countries a preferential trade arrangement with these countries removes the uncertainty of export pessimism that often acts as a restraint in stimulating export production in the developing economies. Secondly, the markets of these countries may act as better

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<sup>5</sup> See H.W. Singer, The Relationship between Debt Pressures, Adjustment Policies and Deterioration of Terms of Trade for Developing Countries (with special reference to Latin America) Institute of Social Studies Working Paper No. 59, July 1989, The Hague.

<sup>6</sup> See P. Sarkar and H. W. Singer: "Manufactured Exports of Developing Countries and Their Terms of Trade Since 1965" in World Development, Vol 19, No.4, pp. 333-340, 1991.

'incubators' in assisting developing countries' producers to acquire the marketing experience in exports that they lack. The markets of the industrialized partners are likely to be sophisticated enough to act as useful 'incubator markets' whilst the preferential arrangement offers them a breathing space by reducing the strength of international competition within the preferential trade area. One can recall the case of the preferential agreements of the EEC with a number of Mediterranean countries in agricultural products (both processed and unprocessed) to see the relevance of this point."<sup>7</sup>

(b) How Should The Gap Close?

(1) Need for Trade Promoting Developmental Government

Active trade promotion requires a partnership of government and business. The establishment of official export promotion agencies is neither a necessary nor a sufficient condition; nor has it been invariably successful.<sup>8</sup> There are many possible forms which the required partnership of government and industry could take. However, the role of an active and selective government policy is large and irreplaceable, whether in fiscal, credit and exchange rate policy, use of diplomatic missions abroad, conclusion of framework agreements and establishment of international treaties and conventions. But the feedback to production to adapt it to the requirements of the foreign market is certainly equally essential and this requires non-official trade promotion facilities and institutions.

Japan, Korea and Taiwan are model examples for active interventionist policies by a developmental state to promote export efficiency. In the case of Japan and Korea this was done on the basis of promoting domestic enterprise capacity, discouraging foreign direct investment, while in the case of Taiwan encouragement of foreign direct investment was an integral part of the policy. In all three cases, this active government intervention can be considered as overall successful. But this overall success was based on special conditions, not easily replicated elsewhere, relating to good macro-economic policies, an enterprise-friendly government with understanding for and good relations with the private sector, effective administration and the existence of a sound infrastructure for trade development. In Korea, preferential finance (subsidized credit) played a major role, but this is a tricky and somewhat dangerous method of trade promotion and its success in Korea should not be taken as a signal for indiscriminate use

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<sup>7</sup> George N Yannopoulos, Trade Policy Options in the Design of Development Strategies, University of Reading Discussion Paper in Economics, Series A, No. 181, November 1986.

<sup>8</sup> See Donald Keesing and Andrew Singer, "Why Official Export Promotion Fails", Finance and Development, March 1992. This article, however, underemphasizes the need for an active government role in trade promotion.

of this specific method of trade promotion elsewhere.

## (2) Modification of Adjustment Policies

The question previously raised as to the nature of the connection between membership in WHFTA and adoption of free market policies can be formulated in a sharpened form by asking: will required adjustment policies be modified to allow for regional cooperation and the establishment of WHFTA as a "genuine partnership" (using President Bush's words) or will the WHFTA be constructed in such a way that it becomes an instrument of carrying out and exerting pressure towards specific reform policies? Naturally this is a highly polarized way of putting things - in reality the negotiations will result in compromises and establish a middle ground between these extremes. These negotiations will necessarily extend over a number of years (perhaps on historical precedent five years after the US presidential elections). During this time the external global environment, the situation in the US and in Latin America as well as development thinking and the views of policy makers both in the North and South (and in the Bretton Woods institutions) may all change. One would assume that LAC countries would wish to keep open the option of active policies in key strategic areas following the East Asian development model (both Japan during the relevant period and South Korea), and to some extent the continental Western European model. In fact such strategic policy intervention could be required for taking full advantage of the new opportunities opening up under WHFTA in the North American markets.

It should be a task for WHFTA to close, or at least to reduce, the present productivity gap. Higher productivity and expanding employment in Latin America would enhance the importance of Latin American/Caribbean domestic markets, and with much of the additional demand directed to non-tradeable or other goods which can be efficiently home-produced, there would be a natural process of efficient import substitution not based on trade obstacles or distorted incentives. When the productivity differential is in fact declining it will then become increasingly safer and more appropriate to engage in further trade liberalization. This has lessons for the sequencing of the various elements of the WHFTA proposal, with trade liberalization complementary to, rather than preceding, a strengthening of the productive base of LAC countries. This is also in line with the relevant development experience of countries like Japan and South Korea.

## (3) Need For Infrastructure

As a general rule one may predict that countries with a larger domestic market, with indigenous technological capacity and with a good infrastructure of transport, information etc will be in a better position than countries without these attributes to derive advantage from WHFTA. In practice this means that the more advanced countries are likely to benefit more and become *pôles de croissance* (growth poles) than more backward countries. The policy conclusion to be drawn is that the poorer countries deserve special consideration and perhaps compensation; and also that the establishment of pre-conditions for seizing opportunities in the poorer countries - infrastructure, technology, information etc - should be assigned a high degree

of priority in implementing the WHFTA.

(4) Need for Aid and Ancillary Policies.

For the weaker partner in trade relations there are two reasons for not opening up to free trade, ie the infant industries argument and the balance of payments argument. Both these reasons are accepted as legitimate, not only in economic theory, but also in GATT regulations - Article XVIII(b). The development of non-traditional exports by LAC countries under a WHFTA regime would inevitably require industries which would have an initial status of infant industries and therefore be in need of initial protection. The balance of payments argument, in the case of Latin American participation in WHFTA, would take the special form of requiring not just balance of payments equilibrium but balance of payments surpluses if the Latin American debts are to be serviced; alternatively there must be an increased inflow of aid or non-debt-creating foreign investment. If there is widespread debt-forgiveness, balance of payments equilibrium would be sufficient - but this is not perhaps a realistic scenario. In one way or another, protection for required new infant industries and balance of payments protection would have to be built into the WHFTA.

The impact of the proposal on aid to Latin America is somewhat ambiguous. President Bush's statement declares that "prosperity in our hemisphere depends on trade, not aid". This recalls the old slogan of the 1960s of "trade not aid". (When Senator Taft, the influential conservative Republican, was asked what he thought of this slogan of "trade, not aid" he replied: "I agree with the second part of it"!)

However, in the same speech President Bush also announced a new fund administered by the Inter-American Development Bank to create a new lending programme "for nations that take significant steps to remove impediments to international investment" to which the World Bank would also be expected to contribute, as well as a US contribution to a new investment fund "in response to market-oriented investment reforms and progress in privatization", with matching contributions from Europe and Japan envisaged. Furthermore, an indirect assurance was given that aid to Eastern Europe would not be at the expense of Latin America. The Enterprise for the Americas Act followed up on these proposals (Title I) by asking for authority to contribute \$500 million in five equal annual installments to an Enterprise for the Americas Fund (the Multilateral Investment Fund - MIF) to be administered by the IADB. It was specified that the Fund could provide programme and project grants as well as technical assistance in connection with privatization. The activities of this Fund were projected to cover domestic as well as foreign investment in Latin America and the Caribbean.

Although the resources of the Fund were very small in regard to the ambitious task the MIF was set to perform, still the proposal to create such a Fund in order to help the LAC countries meet the "indicators of readiness" was a significant initiative. The proposal recognized that an inflow of external resources is a necessary complement to internal reforms. In addition, the MIF initiative recognized that swift, successful adjustment in the investment sector in Latin America requires costly, one-time grant financing, to be used to provide crucial technical assistance, to encourage the investment reform process and to ease the burdens of adjustment,

which the multilateral development banks (MDBs) are not equipped to provide. However, in April 1992 the US Congress refused to vote US funding for the MIF, which meant that matching funds from Japan and other potential donors would be unavailable<sup>9</sup>. In the debt arena, the Congress has enacted separate authority which allows the President to reduce the so-called PL-480 programme and USAID debt of least developed countries which are moving toward market - oriented economies. In this direction, and in order to deal with debt issues in LAC countries, the Initiative proposed an Enterprise for the Americas Facility administered by the Treasury department. Debt reduction, investment reform, and environmental protection were all part of the package. The Facility was designed to support debt reduction programmes for countries that meet certain eligibility requirements:

- (i) The country should have an IMF standby arrangement, an arrangement under the World Bank structural adjustment facility, or in exceptional circumstances, an IMF-monitored programme or its equivalent.
- (ii) The country should be receiving structural or sectoral loans from the World Bank or the International Development Association.
- (iii) The country should have in place major investment reforms in conjunction with an IADB loan or it should be implementing an open investment regime.
- (iv) The country should have negotiated a satisfactory financing programme with commercial banks, including debt and debt service relief if appropriate.

This list of requirements raises an immediate question: is membership in the WHFTA supposed to be conditional on free market reform and "positive changes", possibly verified by an IMF/World Bank "seal of approval"? Or does this list merely express a hope that LAC countries will consider the prospect of free and/or preferential access to the North American markets as an additional incentive to take the risk of plunging into "free market reform"?

The first alternative would clearly limit the freedom of manoeuvre of LAC countries to formulate their own (and possibly divergent) development strategies concerning the size and role of the public sector, exchange rates, monetary policies, fiscal policies, privatization, food subsidies, intellectual property rights etc, and powerfully reinforce pressures to follow policies of stabilization and adjustment ultimately geared to enable them to service debts within an agreed policy framework. However, against this it should be noted that in President Bush's initial proposal there was a direct link with the debt-reduction programme which would reduce the intensity of the adjustment required and thus make it easier for LAC countries to accept and implement reform programmes.

When the above conditions were met, the US would provide new payment terms for

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<sup>9</sup> See Financial Times, 5 June, 1992.

outstanding debt. The Initiative would also provide for the reduction of a portion of assets held by the Commodity Credit Corporation (CCC) as a result of its credit guarantee facilities and a portion of Eximbank loans (EXIM), provided that the eligible country confirmed that debt relief assistance would be used to carry out debt-for-equity or debt-for-nature swaps.

LAC countries currently owe about \$12 billion to the US government. To implement the debt reduction agreements, the US Administration needed Congressional authorization to reduce foreign economic assistance obligations to the US Agency for International Development (USAID), a procedure modelled on the 1990 Farm Bill, which allows countries to reduce PL 480 debts<sup>10</sup>. However the Foreign Aid Authorization Bill of 1991 (incorporating the Enterprise for the Americas Initiative Act of 1991) which sought authorization to reduce EXIM, USAID and CCC debts, was voted down by the House in October 1991.

Thus, of the three "pillars" of the EAI (trade liberalization, investment restructuring and promotion and debt reduction), only the first remains as envisioned by the initial proposals of the Initiative. Earlier in this paper it was stressed that free trade agreements based on negative integration measures can seldom be equally beneficial between partners with sharply disparate levels of per capita income and social conditions. The necessary "catching up" cannot happen without external resources and support, and without some degree of "catching up" LAC countries will not be able to take full advantage of the benefits of WHFTA and participate in a "genuine partnership" in the Western Hemisphere.

#### (5) Focus on People

Apart from the impact on the poorer countries, there is the overall effect on poverty to be considered. This is not only a question of distribution of benefits between countries but also of income distribution within countries. According to World Bank estimates, the number of poor people living below the poverty line in Latin America has almost doubled between 1985 and 1989, to over 100 million people, representing almost one quarter of the total population. This increase was both absolutely and relatively higher than in any other part of the world, even including sub-Saharan Africa (although the incidence of poverty at 25% is less than in Africa or South Asia where it is around 50%). About 70% of Latin America's poor are listed as extremely poor, living below an even lower poverty line; this proportion also is as high as in sub-Saharan Africa and higher than in all other regions. The impact of expanded trade on both the rural and urban poor in Latin America deserves special consideration in any coming negotiations. The analysis of WHFTA should not concentrate solely on technical financial and economic feasibility and consequences, but should include its impact on people. The UNDP with its human resource development experience could offer useful assistance in this direction.

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<sup>10</sup> The conditions and modalities of debt reduction are taken from the Office of the Press Secretary, The White House, 14 September 1990: "Enterprise for the Americas Initiative" Act of 1990, HR 5855.

One would also hope, in this context, that the movement towards a WHFTA is accompanied by greater emphasis on the social impact of structural adjustment programmes; considering the great influence of the US on the policies of the IMF and World Bank, this could legitimately be included in the WHFTA negotiations.

## (5) PROBLEMS OF NEGOTIATION

### (a) Indicators of Readiness

President Bush's initiative on 27 June 1990, for closer economic relations within the Western Hemisphere under the EAI was broadly designed to support the new commitment of Latin American and Caribbean governments to democracy and market-oriented reforms through a programme that would cut trade barriers, promote investment, and help reduce debt.

As a first step, the US negotiated bilateral framework agreements on trade and investment with interested countries in the region. The framework agreements generally contain a statement of principles covering: the benefits of open trade and investment; the increasing importance of services in the economy; the need for adequate protection of intellectual property rights; the importance of observing and promoting internationally recognized worker's rights; and the desirability of effectively resolving trade and investment problems. In addition, each framework pact establishes a Council on Trade and Investment that serves as a bilateral consultative mechanism.

At the time of writing, the US has signed bilateral framework agreements with all LAC countries except Haiti, Surinam and Cuba. But the signing of a framework agreement on trade and investment with a LAC country, or a group of countries, does not imply that the US will propose free trade negotiations immediately. The framework agreements are seen as a mechanism that will enable the US and its prospective partners "to move forward on a step-by-step basis to eliminate counterproductive barriers to trade and investment, and establish a channel to advance the EAI vision"<sup>11</sup>. Prospects for FTA talks depend on progress towards economic reform and political stability.

The Bush Administration has put forward a list of preconditions for FTA agreements under the EAI, which were diplomatically labelled "indicators of readiness"<sup>12</sup>. A candidate LAC country or group of countries must:

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<sup>11</sup> US Department of Commerce, "Enterprise for the Americas", 17 January, 1992.

<sup>12</sup> See US Department of Commerce, Office of Latin America, "Enterprise for the Americas" fact sheet, 30 August 1991.

- (i) "have the economic and institutional capacity to fulfil the long-term serious commitments involved, and the economic policies required for the success of the FTA";
- (ii) "be committed to a stable macroeconomic environment and market-oriented policies before negotiations begin";
- (iii) "be committed to the multilateral trading system (prospective FTAs must be fully consistent with Article XXIV of GATT); and
- (iv) "have demonstrated progress in achieving open trade regimes and be GATT members in good standing."

Some LAC countries are well positioned to participate in the EAI. Others, however, are not yet sufficiently advanced in the process of structural reform and are struggling with short-term obstacles - many of a political nature - which limit their potential to participate in the Initiative.

Entry EAI rules remain an open issue as no decision has been made about whether other countries would accede to the NAFTA or whether separate FTAs would be negotiated. Until August 12, it was believed that the NAFTA itself would probably be the text to which LAC countries would eventually adhere. However, against expectations, there is no "docking clause" in the agreed text which would allow for speedy accession of LAC countries to NAFTA<sup>13</sup>. However, the NAFTA treaty still is an important model for the countries of Latin America and the Caribbean regarding the rights and obligations that the US will expect if they decide to get involved in trade pacts with LAC countries.

The sequencing of prospective FTA negotiations is still not clear, but it is clear that a serious phase of new talks will soon begin especially if the concluded NAFTA is promptly ratified by the legislative bodies of US, Canada and Mexico.

However, assuming that NAFTA will be ratified, there are five possible scenarios as far as LAC countries are concerned:

- (i) As LAC countries meet the preconditions set by the EAI they join bilateral FTA agreements with the USA;
- (ii) FTA agreements are reached between the USA and groups of sub-regionally integrated LAC countries that meet the EAI conditions;
- (iii) As LAC countries meet the preconditions set by the EAI they join NAFTA;

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<sup>13</sup> Financial Times, August 13 1992.

- (iv) NAFTA is extended to include sub-regionally integrated LAC countries that meet the EAI conditions; and
- (v) All LAC countries meet the EAI conditions and join NAFTA at the same point in time.

A complete WHFTA will only materialize if all Western Hemisphere countries enter into a free trade agreement with the USA and Canada. This can happen either simultaneously for all LAC countries if scenario (v) is followed, or step by step in a combination of scenarios 1-4.

#### (b) The role of Regional Groupings

It is not clear what the role of existing regional groupings in Latin America and the Caribbean would be in the process of coming WHFTA negotiations. Would the negotiations be with such regional associations as a single negotiating partner, or would they be with the individual members of such associations? The statement by President Bush is not entirely clear on this point. The statement that "the US stands ready to enter into free-trade agreements with other markets in Latin America and the Caribbean, particularly with groups of countries that have associated for purposes of trade liberalization" would seem to point towards the first alternative, i.e. treating the associations as direct negotiating partners. However, the statement then went on immediately to declare that the NAFTA negotiation with Mexico was "the first step in this process". This is confusing since the negotiation with Mexico is with a single country partner rather than with an existing association of LAC countries. The accession clause to NAFTA would have offered a route to a piecemeal, country-by-country, movement from NAFTA to WHFTA which has been described as "minilateral". From the point of view of LAC countries, piecemeal accession carries a danger of zero-sum games, ie preferential treatment of one LAC country may displace trade of another LAC country exporting similar products to North America.

The relationship between WHFTA and existing or prospective regional groupings in Latin America such as ALADI, the Andean Pact, the Central American Common Market, CARICOM, and MERCOSUR, is clearly a complicated one. In practice it will be difficult to avoid a weakening of these regional groupings as a result of WHFTA. The US is in principle supporting regional co-operation within Latin America, as indicated in the statement by President Bush mentioning the possibility of entering into free trade agreements "with groups of countries". This means that everybody wants to avoid a situation where existing regional groupings are bypassed or even disrupted through competition among individual member countries to enter into direct negotiations on WHFTA and compete for access to the US market and the associated investment and debt packages. There is also a danger that any such bypassing of existing regional groupings in favor of direct negotiations may conflict with the provision common to all existing groupings prohibiting such bilateral treaties and providing that any tariff preference with a non-LAC country (which would include the US and Canada) must automatically be fully extended to the other members of the regional grouping. The most realistic proposal in the

circumstances seems to be that arrived at by SELA<sup>14</sup>. This suggests that the regional groupings should first define a common position concerning the "criteria, rules of the game and issues to be considered" - perhaps leading to a common LAC joint position, while leaving the detailed negotiations and conclusion of actual agreements to individual countries or perhaps sub-regional groupings. This is a suggestion to be carefully considered although the distinction between "rules of the game" and an agenda for the negotiations on the one hand and the actual negotiations on the other hand may not be easy to maintain in the actual unfolding of events - at least this is what experience with the Uruguay Round and other GATT negotiations seems to suggest.

The negotiations for a WHFTA - as already pointed out - will be complicated and time-consuming whether the regional groupings are involved, or whether the negotiations are on a country-by-country basis. This also raises the problem and danger of an unequal partnership. Clearly the administrative and negotiating resources of LAC countries and regional groupings are much more limited than those of the US and Canada. Moreover there are many other claims on the administrative capacity of LAC countries: negotiations have to take place with the IMF and World Bank on structural adjustment, negotiations with official creditors and commercial banks on debt problems, negotiations with aid donors and sources of technical assistance etc. If complex new negotiations on WHFTA are added to other heavy responsibilities, the capacity for dealing with structural adjustment, debt, and aid problems may be adversely affected. All this establishes a case for easing the administrative burden of negotiations as much as possible, eg by appointing lead countries to negotiate on behalf of Latin America on specific issues, using existing institutions such as the Inter-American Development Bank, Caribbean Development Bank, ECLAC, SELA, etc to the greatest possible extent, obtaining technical assistance in the negotiations from UN organizations (for instance assistance from FAO on questions relating to the impact of WHFTA on agriculture, from ILO on the employment effects, from UNIDO on the effects on industry etc).

One major factor further complicating the negotiations is the fact that the major barriers to free trade between Latin and North America are not tariffs but non-tariff barriers which are much less transparent and much more difficult to negotiate. For example, US non-tariff barriers against imports from Latin America have been estimated, in terms of tariff equivalents, as 40% for sugar and clothing, 30% for rice, 25% for dairy products, 20% for textiles, iron and steel and color television sets (with much higher possible high ranges, eg 80% for sugar, 50% for textiles and clothing etc).<sup>15</sup> These NTBs include voluntary export restraints, anti-dumping and countervailing duties, quotas, excise duties etc, all of which may require different negotiation

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<sup>14</sup> SELA The Enterprise for the Americas Initiative in the context of Latin America and Caribbean relations with the United States, consultation meeting on Latin American and Caribbean relations with the United States of America, Caracas 22-24 April 1991, SP/RC-IA/DT No. 2.

<sup>15</sup> See Erzan and Yeats, loc.cit., p. 29.

approaches and are also subjects of various kinds of multilateral negotiations. Multilateral liberalization would of course reduce the value of free trade access under WHFTA.

The inherent inequality in economic weight between North America and Latin America/Caribbean would suggest that from the Latin American point of view it would be preferable to have as much as possible of the actual negotiations take place after defining a common regional position, whereas the US might prefer to negotiate bilaterally or individually with the different sub-regional groupings. Thus the establishment of a proper framework for the negotiations acquires great substantive importance. The relationship between WHFTA and existing regional groupings in Latin America is a mirror image of the relationship between WHFTA and the global GATT system. In both cases the lesser level of co-operation - regional Latin American groupings in relation to WHFTA and WHFTA in relation to global trade liberalization - can be either a stepping stone or a stumbling block.

Perhaps, after a successful conclusion and full implementation of a satisfactory WHFTA, existing sub-regional groupings in Latin America may become less important. However that day is a long way off and meanwhile the WHFTA proposal would give regional groupings additional importance, both as a mechanism of negotiation to improve what is essentially an inferior bargaining position and also as a reassurance or fallback position against failure or delays in the establishment of WHFTA.

### (c) Lessons from the US-Canada FTA and NAFTA

Experience with the US/Canada free trade agreement shows that even in the best of circumstances and with goodwill on both sides an FTA does not by any means resolve all trade difficulties between the partners. Both the fact of the existence of current difficulties and tensions as well as their nature are instructive for LAC countries when they contemplate coming WHFTA negotiations. The existence of difficulties, three years after the initiation of the US/Canada FTA and over a third of the way towards the bench-mark of 1998 for the elimination of all customs tariffs, demonstrates the great importance of an effective agreement on trade dispute settlements. This will not be easy to reconcile with the implicit unilateralism of such US trade legislation as section 301 and of the claim unilaterally to determine injury to domestic producers rather than submit to GATT procedures or deal with disputes by negotiated treaty. (The problem may also apply in reverse if LAC countries wish to prevent injury to domestic producers from cheap US imports.) To avoid future disappointments and friction, this matter should be clearly settled as part of the WHFTA negotiations. There are already precedents for the targeting of LAC countries by 301 and Super-301 actions by the US. Between 1980 and 1985, out of 252 countervailing duties initiated by the US, 51 or 20% were against Brazil and

Mexico.<sup>16</sup> The US/Canada FTA provides a hopeful model of dispute settlement on the basis of bi-national procedures which could be readily extended to WHFTA.

The nature of the tensions in the US/Canada situation is also instructive. To a considerable extent they center on a ruling that automobiles assembled in Canada fail to meet the local content requirement for duty-free access to the US under the FTA. The definition of local content and the operation of rules of origin are notoriously thorny questions liable to give rise to friction. In the case of the WHFTA there would be the added problem as to what extent origin would be determined on a purely national and bilateral basis - say, goods from Brazil admitted duty-free to the US if they satisfy a 50 per cent Brazilian origin - or on a hemispheric basis - say Brazilian goods admitted duty-free as long as if 50 per cent or more originates in the Western Hemisphere. One would imagine that in the spirit of a WHFTA the latter would be the rule. The determination of rules of origin and local content would be especially important to LAC countries in a WHFTA since one of the main advantages of WHFTA to them would be the attraction of foreign investment from outside the hemisphere to take advantage both of lower wages and of free access to the North American market. Since many of these investments would have an assembly element and be based on global components the determination of local origin becomes especially difficult as well as important.

Difficulties in the US/Canada FTA concerning Canadian lumber exports are also instructive as a signal of problems to be considered, and if possible anticipated. The US Commerce Department imposed a tariff on Canadian lumber on the grounds that Canadian sawmills are subsidized by curbs on exports of logs. Under a WHFTA LAC countries would naturally be keen to increase the value of their exports by upgrading their primary commodity exports through additional processing. In the interests of this natural development strategy they might wish to curb exports of primary commodities in crude unprocessed form. Would this be considered as an unfair subsidy to processors to be met by a tariff or other import constraint under a WHFTA?

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<sup>16</sup> Paolo Bifani, "International Trade from the 1980's to the 1990's: The Latin American Perspective", IDS Bulletin, January 1990, p. 80.

- 1 Research assistance from Nicholas Georgiadis is gratefully acknowledged.
- 2 G K Helleiner, 'Towards a New Regional Development Strategy for Latin America in the 1990s' note prepared for a panel discussion at the Inter-American Development Bank conference on Latin American Thought: Past, Present, and Future - Washington DC 14-15 November 1991.
- 3 See Griffith-Jones S., C. Stevens and N. Georgiadis, "Regional Trade Liberalization Schemes: The Experience of the EC", paper prepared for IADB/ECLAC, August 1992.
- 4 But see Refik Erzan and Alexander Yeats, 'Free Trade Agreements with the United States - What's in it for Latin America?', World Bank, Policy Research Working Paper Series 827, January 1992.
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- 7 George N Yannopoulos, Trade Policy Options in the Design of Development Strategies University of Reading Discussion Paper in Economics, Series A, No 181, November 1986.
- 8 See Donald Keesing and Andrew Singer, 'Why Official Export Promotion Fails', Finance and Development, March 1992. This article, however, underemphasizes the need for an active government role in trade promotion.
- 9 See Financial Times, 5 June, 1992.
- 10 The conditions and modalities of debt reduction are taken from the Office of the Press Secretary, The White House, 14 September 1990: "Enterprise for the Americas Initiative" Act of 1990, HR 5855.
- 11 US Department of Commerce, "Enterprise for the Americas", 17 January, 1992,
- 12 See US Department of Commerce, Office of Latin America, "Enterprise for the Americas" fact sheet , 30 August 1991.
- 13 Financial Times, August 13, 1992.
- 14 SELA The Enterprise for the Americas Initiative in the context of Latin American and Caribbean relations with the United States, consultation meeting on Latin American and

Caribbean relations with the United States of America, Caracas 22-24 April 1991, SP/RC-IA/DT No. 2.

15 See Erzan and Yeats, *loc.cit.*, p29.

16 Paolo Bifani, 'International Trade from the 1980s to the 1990s: The Latin American Perspective', IDS Bulletin, January 1990, p80.

