

IDB - ECLAC

JCL

WORKING PAPERS
ON TRADE IN THE
WESTERN HEMISPHERE

WP-TWH-3
May 1992

A Western Hemisphere Free Trade Area: Possible Implications for Latin America

W. Max Corden

INTER-AMERICAN DEVELOPMENT BANK

UNITED NATIONS ECONOMIC COMMISSION FOR LATIN AMERICA
AND THE CARIBBEAN

Table of Contents

	<u>page</u>
Introductory Remarks	1
 I. THE THREE EFFECTS: LIBERALIZATION, TRADE DIVERSION, RECIPROCITY	 3
(1) Liberalization by the LAC	3
(2) Trade Diversion	8
(a) Vinerian Trade Diversion	8
(b) Trade contraction	10
(c) Trade deflection	11
(3) Reciprocity	14
(a) Extent of gain from reciprocity ...	14
(b) Trade diversion and the bandwagon ..	17
(c) Political economy arguments for an FTA	18
 II. VARIOUS OTHER CONSIDERATIONS	 19
(1) Exchange Rate Policy	19
(a) How would FTA affect real exchange rate?	19
(b) Does an FTA require a fixed exchange rate?	21
(c) Dangers of a fixed exchange rate regime	22
(2) Fair Trade versus Free Trade	24
(3) Gains from an FTA for the US	26

Table of Contents

(continued)

	<u>page</u>
(4) A Free Trade Area between LACs	28
(a) Likelihood of net gain	28
(b) Should FTA be turned into customs union?	29
(5) Multilateral Trade Negotiations and the Western Hemisphere Free Trade Proposal	31
(a) How regionalism might affect multilateralism	31
(b) Multilateralism and regionalism compared	33
III. CONCLUSION	35
Bibliographic Note	40

A WESTERN HEMISPHERE FREE TRADE AREA:
POSSIBLE IMPLICATIONS FOR LATIN AMERICA

In 1990 President Bush launched the Enterprise for Americas Initiative, which included a proposal for the establishment of a Western Hemisphere-wide free trade area. The idea is to start with bilateral free trade negotiations, the negotiation between the United States and Mexico being the pilot case, and possibly the Canada-US free trade agreement being a kind of model. The Initiative is concerned not only with trade policy but also explicitly with investment, debt and the environment. Furthermore, experience in Europe suggests that many considerations other than purely economic ones enter into moves towards regional free trade. But this paper will be limited to considering trade policy and, also, will leave aside various broader political issues, though it will make some reference to the political economy of trade liberalization.

The aim here is to provide a framework for analyzing from the point of view of individual Latin American countries the potential gains and losses of forming a free trade area (henceforth FTA). Thus, this paper is basically theoretical, drawing attention to the numerous and complex issues that are involved. The term "Latin American country" or "LAC" will be used as shorthand to refer to all countries in the Western Hemisphere other than the United States and Canada. The paper will ignore Canada, though the analysis could be applied to the formation of a free trade area with Canada as much as with the United States. With apologies, the term "LAC" should also be regarded as including the small Anglophone and Francophone countries of the Caribbean basin.

The main analysis is in Part I of this paper. This distinguishes between and analyzes in detail the effects of (1) liberalization, (2) trade diversion, and (3) reciprocity. The distinction between these three effects of an FTA is very helpful in sorting out these issues.

The analysis in Part I will make three assumptions, all of which will be reconsidered in Part II.

First, it is assumed that the concern is only with the national welfare of the LAC. The special interest of the United States, or any interest group within it, will be briefly discussed in Part II. Thus, this paper is thought of as primarily a guide for analysts and policy makers in LACs. The interest of the world community as a whole will also be ignored.

Second, it will be assumed that the free trade area is a bilateral one between the United States and any one LAC. Of course, FTAs can also be, and have been, formed between two or more LACs, but these have somewhat different implications and will be discussed more briefly in Part II. The immediate issue is certainly the formation of an FTA between a very large and powerful developed economy--i.e., the United States--and various smaller and less developed ones. This is the so-called "hub-spoke" concept. The United States intends to negotiate bilaterally with individual LACs--unless groups of the latter have already formed FTAs among themselves--so the case that will be considered here will be that of a two-country bilateral negotiation.

Third, it will be assumed that macroeconomic adjustments--including exchange rate adjustment and appropriate fiscal and monetary policies--take place to ensure an appropriate balance-of-payments outcome and level of aggregate demand for domestic goods and services. This is the standard assumption in

"real" trade theory and is designed to simplify the analysis a little. The implication of an FTA for exchange rate policy will be discussed in Part II.

I

THE THREE EFFECTS: LIBERALIZATION, TRADE DIVERSION, RECIPROCITY

(1) LIBERALIZATION BY THE LAC

The first of the components of an FTA is trade liberalization by the FTA itself. Tariffs are reduced and possibly removed completely, and quantitative import restrictions are ended or the range of imports to which they apply is reduced. The result is that imports increase, consumers of the imports or domestic producers that use them as inputs benefit, and import-competing producers may be adversely affected. Exporters gain directly through reduced costs of imported and import-competing inputs, and indirectly through macroeconomic adjustment, notably exchange rate depreciation, that is likely to be associated with liberalization. Such gains may also accrue to import-competing producers. Inevitably there are both gainers and losers. Unemployment may increase in the transition. There are also benefits through the reduced rent seeking and administrative costs normally associated with quantitative import restrictions. If tariffs have been high or import restrictions tight and widespread, the effects of trade liberalization on the pattern of domestic output and distribution of income as between different industries and workers may eventually be substantial.

Trade liberalization can actually take three forms--unilateral, multilateral and regional, and it is worth comparing the effects of the three. Table 1 shows that they have some, but not all, effects in common.

Table 1

Effects of Three Kinds of Liberalization

	<u>Unilateral</u>	<u>Multilateral</u>	<u>Regional</u>
<u>Effects</u>			

Liberalization by LAC	✓	✓	✓

Trade Diversion (Adverse)			✓

Reciprocity (Favorable)		✓	✓

First of all, liberalization can be unilateral and non-discriminatory: the policy is pursued because it is believed to benefit the country as a whole, and that in the long run most citizens will gain even though there are likely to be some short-run losers. Hence, it does not need to be associated with any international agreement. Further, it does not explicitly discriminate between different foreign suppliers. Unilateral liberalization was pursued by Chile in the seventies, and more recently by Mexico and Argentina, and to a lesser extent, several other Latin American countries.

Second, liberalization can be multilateral. In the post-war years multilateral liberalization in manufactured trade took place among developed countries under the auspices of GATT. Essentially it means that a country's own liberalization is supplemented by liberalization by others, hence opening up export markets for the country and improving its terms of trade relative to the unilateral alternative. This is the reciprocity effect to be discussed below. Clearly, a country benefits when a given degree of its own liberalization is associated with reciprocal

liberalization by its trading partners, which causes their imports from it to increase.

Finally, there is regional liberalization, of which a bilateral FTA is a special case. In that case, the country's own liberalization does not necessarily apply to imports from all countries, but only to those from the region. In the case of a bilateral FTA between one LAC and the US, the LAC may open up its market only to US goods. There will be the same general effects of liberalization: imports will increase, and there will be gainers and losers, as discussed before. But in this case liberalization is partial and thus discriminatory. The discrimination may create trade diversion effects, to be discussed below. In this discriminatory aspect, it differs both from unilateral and multilateral liberalization. In addition, regional liberalization, like multilateral liberalization, has a reciprocity effect: the other member of the region opens up its markets to the first country's exports.

In considering the effects of liberalization in an FTA, one should distinguish two groups of LACs. The first is a group where unilateral trade liberalization has already taken place to the point that quantitative import restrictions have been completely ended (sometimes with a few exceptions) and tariffs are quite low. This group consists of Chile and Mexico, and if one extends the group to countries where the unilateral liberalization process is well underway, or strong commitments have been made, it also includes Argentina and Colombia. The second group consists of countries which still have extensive trade barriers and no firm commitment to a movement towards near or complete free trade. We begin by considering the first group.

For these countries, one might ask what difference an FTA with the United States would make to the liberalization process and ultimate situation. Obviously, if there were complete,

unqualified, permanent free trade affecting imports of all kinds from all sources, forming an FTA with the US would only have an effect through the reciprocity aspect, to be discussed below. But in practice this condition does not exist and is not likely to. Hence, forming a bilateral FTA would have two effects on the degree and effectiveness of the LAC's own liberalization.

First, it would lock-in institutionally a part of the liberalization. The present degree of liberalization could always be reversed by a future government. But an agreement to establish an FTA would not be so easily reversible, if at all. This is clearly an important consideration for Mexico, a high proportion of whose imports come from the United States. It would be relatively less significant for many of the other LACs, but would certainly still be important. This "locking-in" effect has a political economy aspect: it is a way in which a present liberalization-inclined government can commit future administrations that may wish to revert to protectionism.

The immediate benefit of locking-in liberalization is that it is likely to provide a stimulus for investment. Indeed, even the expectation of an FTA may provide such a stimulus. Any arrangement that ensures that a particular structure of domestic prices and incentives will stay for a long time, rather than be changed unpredictably, is likely to encourage investment. This would be both foreign investment and domestically financed investment, financed possibly by the return of flight capital. This effect can currently be observed in Mexico. Furthermore, investors in export industries, especially those that export to the United States, will be encouraged by the prospect not only of ensured open markets in the United States but also of the ability to permanently obtain imported components and inputs without restrictions or tariffs.

Second, it is likely that an FTA would involve a greater degree of liberalization and of opening-up the economy than is likely to result from any degree of unilateral liberalization, even if the latter apparently leads to free trade. Trade is likely to be fostered by various measures of harmonization and elimination of barriers to trade other than tariffs and quantitative import restrictions. Here the example of the European Community can be cited. The first stage was to establish an area of conventional free trade (plus a common external tariff, which made it a customs union). The second stage was the "1992" program--the "completion" of the European market, which had disposed of numerous barriers apart from tariffs. It certainly seems that this second stage is likely to be substantially trade-creating. It is hard to say how important this "completion effect" would be in an FTA formed between any particular LAC and the US, but it could be significant.

Let us now turn to the other group of countries--those where protection is still quite high and where it is unlikely that unilateral liberalization would go anywhere close to free trade. These are countries where currently either the political will to liberalize substantially, or the political ability to bring it about even if there is the will, does not exist. The most important country of this kind is Brazil: liberalization, both actual and prospective, on the basis of commitments, has been substantial, but it is still a long way from free trade. In these cases, the formation of an FTA would raise very substantive issues for the LAC, namely, the very same issues that arise when considering unilateral liberalization.

Are there arguments for protection from a national point of view--for example, the (sectional) employment or the infant industry arguments? Are there significant rent seeking and administrative costs of protection to set against these arguments

if the latter are thought to have some validity? Has the actual practice of import-substituting industrialization been shown to have had adverse consequences and, by contrast, have outward-looking policies as pursued in Latin America by Chile and in Asia by the Republic of Korea and others, been shown to be a success? Even if an ultimate situation of trade liberalization were desirable, is the process of getting there too costly? Would powerful interest groups resist liberalization and make it politically impossible or at least very painful? Should losers be provided with compensation or can one rely on an increased growth rate resulting from liberalization eventually compensating even the initial losers?

It is obviously impossible to discuss these very substantial issues here. Many arguments for protection have come to be discredited, at least at the level of theory, and, perhaps more important, empirical evidence is very convincing that outward-looking policies have led to, or been associated with, higher growth rates. Nevertheless, it can be assumed that in LACs, as in all other countries, including the United States, protectionist ideas and thinking are thoroughly alive--even when past experience has been very bad--and therefore have to be carefully considered. Furthermore, even if there is general agreement that the broad long-term national interest would be served by extensive trade liberalization, possibly to the point of complete free trade, this will not be in the interests of particular groups, and when governments are not strong, interest groups will have blocking capacity.

(2) TRADE DIVERSION

We come now to the principal negative aspect of an FTA, namely, trade diversion.

Trade diversion results from the discriminatory aspect of an FTA. If Mexico maintains tariffs on imports from Japan, and possibly even increases them, while removing tariffs on imports from the United States, there will be some tendency to divert purchases away from Japan towards the United States. The pattern of imports will change. In addition, total imports are likely to increase, this being the trade creation effect. But the trade diversion effect is adverse. Mexico will be buying goods from the United States that could have been obtained more cheaply from Japan.

One can distinguish "Vinerian trade diversion," "trade contraction," and "trade deflection," beginning with the first.

(a) Vinerian trade diversion

Suppose the LAC has a given tariff of 30% on all imports of a particular product to start with. It then joins the FTA and imports from the US can come in without paying any tariff. But imports from Japan must still pay a 30% tariff. This external tariff does not change. There will then be a diversion of the source of imports from Japan to the United States. Excluding the tariff, the diverted imports will have cost less when bought from Japan than when bought from the United States, so that the LAC is now buying a product from a dearer source and thus incurring an extra cost. This trade diversion concept first introduced by Jacob Viner--hence called "Vinerian trade diversion" here--assumes that the tariff on imports from outside (Japan) remains unchanged when the country joins the FTA.

Vinerian trade diversion could well be significant when tariffs on imports from outside the FTA remain high. But the more the LAC has followed a path of unilateral trade

liberalization before joining the FTA, and hence the lower is the external tariff, the less the cost of such trade diversion will be. Nevertheless, some degree of trade diversion is likely even when a country has liberalized completely. This is because of the locking-in and completion effects discussed above. These will foster trade within the FTA relative to trade with the outside world, at least marginally.

Vinerian trade diversion arises when trade with the outside world is restricted by tariffs. It does not arise when it is restricted by given import quotas, provided these continue to be effective in restricting imports even after the FTA has been established. If the upper limit to the value of imports from Japan is fixed by a quota, and provided the trade diversion effect does not reduce the LACs' demand for imports from Japan to a level below this limit, there will be no trade diversion effect. But this qualification is probably not important, first, because in general quotas have been replaced by tariffs, and second, because there is no reason to expect the sizes of quotas to stay unchanged as a result of the establishment of the FTA. This, then, leads into the second concept, namely, "trade contraction."

(b) Trade contraction: Increase of protection
against imports from outside

There is "trade contraction" if the level of the external tariff is actually raised as a result of the establishment of the FTA. In the example above, imports from Japan will decline even more than they would when there is only Vinerian trade diversion. In an FTA, unlike a customs union, the external tariff for a particular product does not have to be the same around the whole area--i.e., the LAC does not have to adopt the US tariff on imports from Japan, or to agree on a common external tariff.

In principle it is still free to choose its external tariff structure.

There are two reasons why the external tariff might well increase. First, it may be brought about as a result of pressure from the United States if the US's own external protection is relatively high, so as to avoid "trade deflection" (discussed below). Second, it may be a natural response to domestic pressure groups seeking more protection from imports when they find themselves harmed by US imports. In other words, when a particular protected industry loses sales because of increased imports from the US resulting from the establishment of the FTA, it may seek, and successfully obtain, higher protection against imports from Japan.

Similarly, if there is a general loss of competitiveness by the country, possibly because the exchange rate has become overvalued owing to a burst of domestic inflation, the natural reaction will be--as it had often been in the past--to increase protection, and once the FTA has been established, this can only be brought about by increasing protection against imports from outside the FTA. It has in the past, and may again, take the form of tightening or expanding the scope of quantitative import restrictions, rather than raising tariffs. Other non-tariff devices, such as anti-dumping measures, countervailing duties, and voluntary export restraints accepted by exporters under threat of other measures can bring about the same result.

(c) Trade deflection: Free trade area versus customs union

Finally, we come to "trade deflection." Suppose that the United States imposes voluntary export restraints or other restrictions on imports of a particular product from Japan while imports of the same products from Japan can come in freely or

at a low rate of tariff from the LAC. There will then be some tendency for goods to be imported from Japan into the US via the LAC. This is trade deflection. It leads to unnecessary transport costs. More important, it defeats the purpose of the US protectionist measures. The lower the transport costs, and the bigger the gap between the low tariff of the LAC and the high tariff of the US (or the tariff equivalent of the non-tariff device), the bigger this effect will be.

The problem is well known in an indirect form (and has presented problems in the Canadian-American free trade area). A country may import duty-free components of a car from Japan, then assemble them, and export the assembled car to its free trade partner--a partner which, itself, imposes restrictions on imports of components from Japan. Thus, the US may wish to restrict imports from an LAC on the grounds that these embody components or inputs that are just "trade-deflected."

The standard solution to this characteristic problem of a free trade area is to make "rules of origin" for trade within the FTA. This raises various technical problems--e.g., the choice of the ratio of domestic component that is acceptable if intra-FTA trade is to be free--and these cannot be discussed in detail here. For a particular product, tariffs will be applied to a proportion of the value of imports from (say) the LAC to the United States, the proportions representing the part that is assumed to be of outside (e.g., Japanese) origin. The United States negotiating position with Mexico, as with Canada, has been to favor strict rules of origin, especially in the automotive sector. Such rules of origin mean that one of the main potential advantages of an FTA--the removal of formal barriers to trade within the area--cannot be achieved. If nothing is done, and trade deflection does take place, the net result is that countries that have high tariffs (or other restrictions) against imports from outside the area will find these tariffs

evaded, and so will have an incentive to reduce them. In other words, the low tariff (or low protection) countries will tend to set the tone for the whole area.

If one favors trade liberalization, one would regard such trade deflection desirable, but, naturally, it is not acceptable to the more protectionist country. Another possibility--that cannot be ruled out but would certainly be less desirable--is that the United States applies pressure on its LAC partner to increase its restrictions on imports from Japan to the US level, so as to reduce the incentive for trade deflection. It must also be added that this analysis is, at least in theory, symmetrical: US protection may be low and the LAC's protection high. In that case, trade deflection would consist of imports from outside entering the LAC indirectly via the US, and the LAC may then wish to apply strict rules of origin.

One might think that the obvious solution is to convert the FTA into a customs union. An FTA and a customs union are both areas of free trade. But, in addition, a customs union is (like a single country) an area with common barriers against imports from outside. This means that there would be a common external tariff, and possibly other common restrictions, such as anti-dumping duties. In a customs union there would have to be an agreement about common non-tariff barriers, notably voluntary export restraints. But it is hardly conceivable that this could be brought about between any LAC and the United States. It is not surprising that it is not under consideration.

In practice a customs union would mean that the external trade barriers of the LAC would be determined in Washington DC, since it is inconceivable that the US Congress would allow relatively small economic partners--all countries in the Western Hemisphere being small relative to the US--to play a significant part in determining its barriers against imports against, say,

Japan. It is also possible that the United States passes through its current protectionist phase and wishes to liberalize imports from outside, possibly on the basis of multilateral or bilateral negotiations. It is improbable that it would allow small LAC partners to play a part in, or even veto, its negotiations.

(3) RECIPROCITY

The most important gain that an LAC is likely to obtain from an FTA is the reciprocal opening--or commitment to continued opening--of the US market to the LAC's exports of goods and services. In this respect the FTA is far preferable to unilateral liberalization. Essentially there are two trade creation effects from the establishment of an FTA: first, the trade creation that results from the LAC's own liberalization (which could be even greater under unilateral liberalization), and second, that which results from US liberalization. If the general, comparative advantage gains-from-trade propositions are accepted, it follows that both countries gain from both forms of trade creation (though there are also some offsetting terms-of-trade effects to be considered).

(a) Extent of gain from reciprocity effect

The extent of the gain to the LAC depends not just on the level of existing barriers to its exports in the US but on what these barriers might have been in the future if no FTA were established. There is certainly a possibility that the Uruguay Round will fail and (even if it formally succeeds), that the US becomes more protectionist. Its protection might be aimed more at countries outside the Western Hemisphere, such as other countries in East Asia, but, in the absence of an FTA, LACs could well suffer from an overspill effect and from the general rise in

US protectionist sentiment. The attraction of an FTA would then be to lock-in the present relatively open trade policies of the US with respect to the LAC. This has been called the "safe-haven" effect.

For given initial and potential barriers, the extent of the gain from their removal depends, in addition, on the extent to which the types of goods and services that the LAC exports are substitutable with competing products in the US. In many cases this substitutability is likely to be high, so that considerable gains might ensue.

The central questions, of course, are how big the barriers are now, what they might be if no FTA were established, and to what extent they will be genuinely reduced in an FTA. For each LAC where the FTA possibility arises, a separate detailed analysis would have to be made. Measurement of existing barriers is usually difficult because the main barriers are non-tariff ones, notably the threat of anti-dumping duties and various "safeguard" provisions. Estimates of what the barriers might be if no FTA were formed involves imaginative judgments. But it is also important to note that an FTA might allow many loopholes and special arrangements so that, in effect, assured free entry of LAC goods into the US will not be provided. The US market may not be so "safe" a "haven." In the cases of the US-Canada agreement and the likely agreement with Mexico, there are provisions for a lengthy transition period during which trade will certainly not be completely free. It is clearly in the interests of the LAC to negotiate an agreement that will minimize the special cases and loopholes. But, of course, the LAC would also have to give up some of its own loopholes.

The value of an FTA to the LAC depends crucially on how the "safeguard problem" is handled. It is inevitable that some producers in the US will be adversely affected by the FTA, or

at least that they will expect to be adversely affected. Usually they have plenty of warning of what might happen, but sometimes the adverse impact can indeed be quite sudden. It is thus natural that they should seek temporary relief or "safeguards against market disruption." Such measures have been allowed under GATT and also the US-Canada agreement. They are extremely common. But they represent the reentry of protection by the back door. Measures are not usually temporary and, above all, they introduce uncertainty.

An LAC exporter who has, often with difficulty, penetrated a market in the US, must always cope, not just with the normal threat of new competitors, which must be faced by all market participants, but also with the threat of government intervention resulting from successful lobbying. Of course, exactly the same problem would arise for US exporters in the LAC market if the same protection-by-the-backdoor policies are followed there. It has to be borne in mind that a genuine FTA would avoid such safeguard interventions for the same reason that within a single country such interventions are not usually provided. The hope is that--after a lengthy transition period--such a genuine FTA would emerge.

If governments are concerned with localized unemployment resulting from increased competition from exporters in the FTA partner country, it is better that they devote resources to supporting labor retraining, labor mobility and improving the local infrastructure so as to attract new investments. Nevertheless, the political acceptability of an FTA may depend on the incorporation of some safeguard provisions in the agreement. In that case, it is crucial that all safeguard provisions be temporary, with built-in sunset clauses, i.e., clauses that ensure automatic ending of a protectionist measure within a limited period of time.

(b) Trade diversion and the bandwagon

One component of the reciprocity effect for the LAC is US trade diversion. This refers to trade diversion by the US, and benefits the LAC, although it harms both the US and the other countries whose trade is diverted in favor of the LAC. It is to be distinguished from trade diversion by the LAC itself, discussed earlier, the effects of which are clearly adverse for the LAC. The effect of US trade diversion will be greater the higher is the substitutability of the LAC's exports with those of competing countries. Considerable losses could be inflicted on the latter, for example, when Mexican labor-intensive exports replace those from Asia. It is part of the reciprocity effect because it results from the removal or reduction by the US of its barriers on imports from LAC while maintaining some barriers, actual or potential, against imports from outside. Of course, if the US forms an FTA with more than one LAC, say Mexico and Chile, there is no trade diversion between imports from these two countries; the adverse effect is borne by other countries, including other LACs.

This potential trade diversion effect provides a particular incentive for individual LACs to join the FTA bandwagon. When LAC No. 1 forms an FTA with the US, there could be an adverse effect on LAC No. 2 through US trade diversion, so No. 2 now has a stronger reason than before to follow the leader. Insofar as there is a good deal of competitiveness between various LACs, once this process gets going there could be a very rapid bandwagon effect. Of course, there is no reason why it should stop at the Western Hemisphere. Furthermore, the more countries join, the less the gains for the early joiners. To put it simply and crudely, it is in the interests of Mexico that the United States allows Mexican goods complete and assured free entry into the US market while imposing tight protection on all other

imports that compete with Mexican goods, and while Mexico itself has free trade with everyone. But, of course, this is not in the interests of the United States.

(c) Political economy arguments for an FTA

Finally, it is worth noting that a country's own liberalization may be politically easier when it is part of a move to an FTA than when the liberalization is unilateral.

Liberalization may be desirable from a national point of view but may be blocked either by interest groups or by lack of popular understanding of the gains from free or freer trade. There are then strong political economy arguments in favor of an FTA.

First, countervailing export interest groups will emerge that expect to benefit from the reciprocity aspect of the FTA--e.g., the opening-up of the US market. Such interest groups have also emerged in the case of unilateral liberalization when this is associated with devaluation; in Chile and Mexico, also, exports have increased. Thus this consideration is only a matter of degree. But the benefits to potential exporters from a unilateral liberalization of imports associated with devaluation are more indirect, and sometimes hard to imagine in advance, compared to the benefits from direct opening-up of a foreign market. Second, the sentiment in favor of liberalization will certainly be strengthened by the reciprocal liberalization in the US. Whatever economists may say--that unilateral liberalization is usually beneficial even when trading partners remain protectionist--the popular instinct is to think in terms of reciprocity and fairness.

II

VARIOUS OTHER CONSIDERATIONS

(1) EXCHANGE RATE POLICY

(a) How would an FTA affect the real exchange rate?

Unilateral liberalization on a large scale almost inevitably requires a real depreciation to precede it or to be associated with it. Thus, there is a close connection between trade policy and exchange rate policy. This connection can be found in many episodes of liberalization in the past.

Liberalization of imports on its own is likely to increase the volume of imports and hence, on that account, worsen the current account of the balance of payments. It may have some offsetting effect through reducing the costs of exports that use imported components or inputs, and hence increasing exports. But it is a reasonable presumption that the net effects on the balance of payments would be adverse. A real devaluation, by contrast, makes import-competing industries more competitive, hence to some extent offsetting the adverse effects of trade liberalization on previously protected industries. More important, it improves the competitiveness of export industries. It may be desirable for the real devaluation to precede trade liberalization so as to ensure that the boost to exports happens in good time, and that extra jobs are available in export industries to compensate for those that may be lost as a result of trade liberalization. But it must also be remembered that industries that use imported inputs will gain from trade liberalization, and employment there is likely to increase.

The real devaluation can be brought about by a once-for-all devaluation, or possibly by a devaluation in several steps,

followed by a fixing of the exchange rate. A more common situation in Latin America is that some kind of crawling peg or frequently adjustable exchange rate regime operates, and frequent nominal depreciations, possibly on a regular basis, take place to compensate for the country's higher inflation rate relative to its trading partners, notably the United States. The aim of such a "flexible peg" exchange rate regime is to keep the real exchange rate constant, or at least to avoid higher inflation leading to real appreciation. In that case, a real depreciation is brought about by ensuring that for some limited time the nominal exchange rate is depreciated faster than the inflation rate differential.

While unilateral liberalization by the LAC requires associated real depreciation, this is not necessarily so when an FTA is formed. The reason is that the reciprocity effect--i.e., the boost to exports resulting from the US opening up its market--will improve the current account, and may compensate for the adverse effect of the country's own liberalization. It would be a pure coincidence if the compensation were precise; on balance some real exchange rate adjustment may still be required, but one can no longer be sure that the need would be for real depreciation, rather than appreciation. If there is no significant inflation differential between the LAC and its trading partners, it may then be possible to sustain a fixed exchange rate commitment, if such has been made.

The formation of an FTA--and indeed just the expectation that it will be formed--could boost capital inflows into the LAC, at least temporarily. If that is so, and if the extra domestic investment which the capital inflow finances is not offset by a reduction in the fiscal deficit, the current account will, and should, go into deficit to allow the transfer of resources (i.e., the use of foreign savings) which capital inflow is meant to bring about. In that case a real appreciation would be required.

To obtain the net real exchange rate effect, this real appreciation effect of capital inflow has to be combined with the effect on the real exchange rate of the LAC's own trade liberalization combined with US liberalization as part of the FTA. Thus, there could, on balance, be either real depreciation or appreciation.

A real appreciation could come about through nominal appreciation--resulting from the additional supplies of foreign exchange causing the value of the domestic currency in the market to rise or--if exchange market intervention prevents such a rise--by a temporary increase in domestic inflation brought about by monetary expansion resulting from the accumulation of foreign exchange reserves. Thus, real appreciation is compatible with a fixed nominal exchange rate, provided there is a willingness to accept some extra, possibly temporary, domestic inflation.

(b) Does an FTA require a fixed exchange rate?

A central issue is whether a fixed exchange rate regime is needed to make an FTA work. Must the LAC fix its currency to the dollar in order to form an FTA with the US? The brief answer is: definitely not. It is certainly possible to have an FTA with exchange rates within the area varying, either frequently or occasionally, or even floating relative to each other. Trade has been free within the European Community, and yet, under the European Monetary System, there have been many exchange rate realignments. Over a long period a substantial part (though not all) of trade between the United States and Canada has been effectively free from restrictions, and yet the Canadian dollar has floated relative to the US dollar. It follows therefore that a further step, namely, monetary integration--which requires a single central bank--is not necessary to have trade integration.

One can thus give a simple answer as to what is possible and necessary. The answer to the question as to what is desirable is more complex.

There is no doubt that a fixed exchange rate fosters both trade and capital movements. It is certainly an advantage for trade if exchange rate uncertainty and the inconveniences associated with having different currencies are removed. If trade integration is to be really complete, as it is within a single country, then the exchange rates should be firmly locked together. This would require a firm institutional commitment. Possibly the LAC might establish a currency board system where domestic currency can only be created when backed by dollars. Something like that has been instituted in Argentina.

The opportunity might also be taken to link the establishment of the FTA with a commitment to low inflation through an exchange rate commitment. The option to discipline domestic fiscal and monetary policies through making the exchange the "nominal anchor" exists in any case, and does not require an FTA. But it is possible that a move to a fixed exchange rate regime would be politically more acceptable--and more credible in the labor and foreign exchange markets--if it were associated with the establishment of an FTA. However, it has to be emphasized that such a link is in no way necessary to bring about an FTA, or to ensure that the FTA brings about net gains.

(c) Dangers of a fixed exchange rate regime

The dangers of attempting a fixed exchange rate commitment must also be stressed, and it is by no means clear that the "exchange-rate-as-nominal anchor-approach" is preferable to a more direct attempt to rein-in inflation by a disciplined fiscal policy. The dangers are three.

First, the exchange rate commitment may be unsuccessful in disciplining fiscal policy, and fiscal deficits may continue to be monetized. In that case, the attempt to maintain a fixed exchange rate will lead to a foreign exchange crisis and eventually compel devaluation. There have been numerous episodes of this kind in Latin American history in the seventies and early eighties; it is clearly preferable for exchange rate adjustments to be frequent and small rather than infrequent and large, always resulting from crises.

Second, for some time it may be difficult to establish the credibility of the fixed exchange rate regime in the labor market and the foreign exchange market, hence leading to continued domestic wage and price rises, and thus real appreciation, and eventually to a foreign exchange crisis.

Third, past experience shows that countries which are unable or reluctant to devalue when they have balance-of-payments problems--caused perhaps by a deterioration in the terms of trade, or a cessation of capital inflow (as in the early eighties)--impose or expand the range of quantitative import restrictions. This is the most important danger of a fixed exchange rate commitment.

It is true that increases in trade restrictions, whether in tariffs or quantitative restrictions, are substitutes for devaluation as "switching devices"--i.e., policies that switch domestic demand from imports towards home-produced goods, and that switch domestic output in the opposite direction. But import restrictions fail to foster exports, and also distort the pattern of imports and domestic production, thus being much less desirable. If trade restrictions are likely to increase as a result of a nominal exchange rate being fixed, and no longer adjustable, one should think twice about making the exchange rate commitment. In an FTA the trade restrictions that would

be increased in case of a balance-of-payments problem would be imposed only on imports from outside the area. In other words, they would not be imposed on imports from the US. Not only the LAC's own producers would be protected but also US producers that export to the LAC. This means that trade diversion by the LAC would increase, and hence the costs of the FTA would rise.

(2) FAIR TRADE VERSUS FREE TRADE

A popular argument against free trade is that the advantages foreign countries have in exporting particular products are not "fair." They do not stem from superior efficiency of a company or from a particular natural resource endowment, but from other factors. These may be "fundamentals," such as a higher ratio of, say, unskilled to skilled labor and to capital, so that the real wages of the unskilled are lower, or from various government policies.

A Mexican company struggling with a relatively poorly educated workforce may regard the greater expenditures on education in the United States as giving its US competitors an "unfair" advantage. In other fields, the high level of military expenditures in the United States may have given some defense industries an advantage. It is not hard to think of advantages that US industries have relative to those of an LAC, some of which may be attributable to particular US government policies. But in general the US does not follow an "industrial policy," so that there are few if any cases where one can say that particular industries (other than defense industries) have been subsidized either directly or indirectly. It is unlikely that the US would change any of its domestic policies to respond to such complaints from a potential FTA partner. Surely, it would not wish to adjust its educational system so as to reach that of poorer neighbors!

The issue is much more likely to arise in the other direction. The US may complain about "unfair" competition from the LAC. US critics of the proposed FTA agreement with Mexico make such complaints, especially with regard to labor and environmental regulations, as well as low wages in general. If an LAC is to form an FTA with the US, it may be required to change certain of its domestic policies so as to avoid complaints of "unfair" competition. This could be an important implication of an FTA. The pressure from US interest groups is both inevitable in this respect and fully understandable. The question is whether altering its various domestic policies would be in the interests of the LAC or not. If not, we have here a cost of an FTA, to be added to the trade diversion cost. For example, the LAC will have regulations protecting workers and their conditions which are much less strict than those prevalent in the US. If the same regulations were introduced as existed in the US, labor costs would rise for firms, and the effect would be much the same as if real wages had been increased. The LAC would lose some of its comparative advantage stemming from cheap labor. In general, to seek to equalize wage cost--a farfetched idea--would be to negate comparative advantage.

How is one to look at this issue in a general way? Any country has a pattern of government interventions in its economy, including subsidies, direct and indirect, to particular industries, regions or sections of the community. There are regulations of various kinds, whether on transport, on workers' conditions, or designed to protect the environment. There are various special taxes. Some of these benefit foreign competitors of the countries' exporters; others harm them. Some are the results of pressures from interest groups, of historical and now irrelevant factors, or of unsound theories. Others can be described as "optimal" from a national point of view using standard economic criteria, or at least can be regarded as having moved the economy closer to an optimum. If joining an FTA leads

a country to give up "non-optimal" interventions--perhaps interventions which a well-meaning government (or its economic advisers) may have wished to remove but was unable to do so because of strong interest groups--then there is a benefit in this respect from the FTA. Similarly, joining an FTA may lead to new interventions (e.g., to protect the environment) which are optimal, in which case there is again a benefit. On the other hand, the LAC may be required to give up interventions that are optimal, in which case there is a net loss.

The obvious question is: who decides what is optimal, and if an intervention is non-optimal, why has it not been removed in any case? Presumably, one must simply look at each intervention under discussion case-by-case. If one takes the view that the existing pattern of interventions--whether subsidies to particular industries, or lack of environmental controls, for example--must be optimal just because it is what the government of the LAC has chosen, one would regard the pressures applied by the US negotiators in the interest of "fairness" as perceived by the US pressure groups as necessarily harmful. But I would take the view that the pressures could sometimes have a beneficial effect, for example, if they lead to the abandonment of subsidies that were not justifiable on purely (national interest) economic grounds, or if they lead to environmental measures that take external diseconomies appropriately into account.

(3) GAINS FROM AN FTA FOR THE UNITED STATES

The US is a very large area of free trade (actually, a customs union) already, and it is unlikely that the gains relative to GNP from forming an FTA with any LAC, or even all LACs, would be very large, whatever policy the LAC follows. In general, when a large and a small economy form an FTA, the small economy is likely to gain much more relative to its GNP. The

principal gains to the US could well be political, or they could stem from reduced pressure for immigration, especially from Mexico, resulting from the gains to the LAC being large. Particular US companies that perceive profitable investment opportunities as a result of the FTA would also gain.

Suppose the LAC liberalizes unilaterally and then forms an FTA with the United States. If one regards most or all relevant arguments for protection as unsound or not applicable to the LAC, that would be the best policy for the LAC. It would eventually obtain guaranteed free entry into the US market, and yet it would not lose from any trade diversion away from (say) Japanese exports towards US exporters. But would there be any gain for the United States? Leaving aside non-trade considerations, one might ask why the US should commit itself to an FTA if the LAC would liberalize unilaterally in any case?

The answer is that there would still be a gain for the US even when the LAC liberalizes relative to all other countries as well. This is the "locking-in" gain. Liberalization by the LAC of imports from the US will be locked-in by the FTA, while the liberalization on imports from outside the area could always be reversed. US exporters gain certainty. This gain to US exporters will, of course, be greater if the LAC maintains protection against imports from outside.

In principle, the analysis of the economic gains and losses to the US of joining an FTA is the same as that applicable to the LAC. The US will gain from trade creation and from trade diversion by the LAC, while losing from its own trade diversion. It can avoid its own trade diversion by itself following a policy of unilateral free trade relative to outsiders. But when particular US industries are under competitive pressure either from the LAC, or from outside, an increase in protection is likely. On the basis of past experience, this normally takes the

form of voluntary export restraints or anti-dumping duties. If protection on imports from the LAC cannot be increased owing to the FTA (and there are no loopholes), the extra protection on imports from outside will be all the greater. The need to focus all the extra protection on imports from outside produces a trade diversion cost for the US relative to the alternative of increasing protection in a less discriminatory way.

(4) A FREE TRADE AREA BETWEEN LACS

The whole of the preceding analysis is relevant for studying the implications of the formation of an FTA between any group of LACs. If one stays with generalities, one would simply be repeating what has been said: there are trade creation, trade diversion, and reciprocity effects; trade diversion will be greater the less liberalized is trade with the outside world.

(a) Likelihood of net gain

If, in the absence of an FTA, trade with the outside world would be the major part of an LAC's trade, then the trade creation gains are unlikely to be large and--if high levels of protection relative to the outside world remained--the losses from trade diversion might well be greater. Following exactly the same argument that was given above, if one regards protection as not in the national interest, the best policy for any one LAC is to liberalize unilaterally imports from all sources and then form an FTA with other LACs so as to obtain free entry there, and hence obtain the reciprocity gain. It will then get both a trade creation gain and a reciprocity gain, but suffer no trade diversion loss.

As also noted earlier, the possibility of an FTA bringing about some trade diversion does still exist if a country's

liberalization relative to the outside world is not complete or does not involve a firm commitment. But, leaving that qualification aside, the conclusion is that an FTA would be a good supplement for unilateral liberalization. Possibly some net gain might remain even if unilateral liberalization were not complete. But, in view of the relative importance for all LACs of trade with countries outside Latin America, unilateral liberalization is the more important step.

(b) Should the FTA be turned into a customs union?

The question also arises whether an FTA between two or more LACs might be turned into a customs union. From the point of view of the members of the union, this would have one important benefit. By creating a common tariff and import control structure, it would provide a large bargaining group. If the proposed FTA with the US would not immediately be a complete FTA, but rather initially some kind of preferential area--with provision for safeguard interventions and other loopholes, as well as a gradual process of tariff reduction--there would be particular bargains to be struck. Hence, the larger the LAC bargaining unit the better from the LAC point of view. Of course, if the FTA with the US is to be complete, there is nothing to bargain about with regard to tariffs and other restrictions relative to the US, and this factor disappears. But the bargaining argument is still relevant when the group bargains with other (non-Western Hemisphere) countries, or multilaterally.

It has to be borne in mind that it is not necessary to have a common external tariff or trade policy to form a bargaining group in multilateral discussions. Various groups of developing countries have operated in the Uruguay Round negotiations, groupings varying with the issues, and the most influential group

outside the Big Three economic powers (US, European Community and Japan) has been the Cairns Group of agricultural exporters.

The step from FTA to customs union can have various effects, depending on whether it leads to increased or decreased protection on imports from outside. The customs union may be desirable to avoid trade deflection, but it is certainly just as important that the external tariffs be low. Also, of course, it introduces a major burden on negotiations: in principle, it is much easier to decide to establish an area of complete free trade than to agree on a common external tariff structure, especially when existing tariffs and other trade restrictions are high and important to particular industries.

It is also important to avoid a situation where the establishment of the customs union provides a new platform for protectionism, giving new life to protectionist ideas. It is certainly true that the costs of protection (as a proportion of GNP) tend to be greater the smaller the economic size of a country, since small economies have the most to gain from free or freer trade. Hence, the formation of an FTA or customs union between several LACs will reduce the costs of protection resulting from given rates of tariff, and there will be gains to be derived from economies of scale. But there will still be costs of protection, and they will still be large (unless rates of protection are low) because even the largest economy--Brazil--is only of modest size by world standards, and has much to gain from trade. Any likely grouping of LACs will not add up to an economy so large that considerable costs of protection can be avoided.

Of course, this is a generalization. Measurement is difficult, and judgments have to be made on a case-by-case basis. But the maximum benefits from economies of scale can be derived

not by creating a larger domestic market in the form of a free trade or customs union but by aiming exports at the world market.

(5) MULTILATERAL TRADE NEGOTIATIONS AND THE
WESTERN HEMISPHERE FREE TRADE PROPOSAL

One may regard multilateral free trade--or at least substantial world-wide liberalization supported by strong rules--as preferable to regional arrangements. This is certainly my view and will be further discussed below. But the prior issue is whether a movement towards regionalism--of which the Western Hemisphere Free Trade Agreement proposal is a major example--is likely to foster or to discourage the success of multilateral negotiations and the rules and processes of the GATT system. In other words, we need not only to compare them as alternatives from the point of view of an LAC--which will be done below--but also to consider how an FTA would affect the achievement of improved multilateralism.

(a) How regionalism might affect multilateralism

In summary, regionalism can be seen as a supplement to multilateralism, as an alternative or as a path towards it. The official US position is certainly that it is a supplement, and that any FTA decisions must work within the framework of GATT and the Uruguay outcome. In this view, regionalism is no obstacle to progress in the multilateral liberalization. The matter is complex, but broadly, in the US the supporters of a favorable Uruguay Round agreement and of an FTA with Mexico tend to be the same, while protectionist sentiment is directed both against possible implications of Uruguay Round agreements and against the proposed FTA with Mexico. One can certainly conceive of various FTAs around the world being supplemental to a new multilateral system which strongly regulates trade restrictions and brings

about a good deal of liberalization. The main point is that, within its limited area, the FTA is likely to go further in liberalization, being then a true supplement.

But regionalism can also be an alternative to multilateralism. There is certainly evidence that the members of the European Community have been less committed to ensuring the success of the Uruguay Round because of their preoccupation with the completion of the internal market (the "1992" program) and, more generally, because, given the large and expanding area of genuinely free trade that they are creating for themselves, they see less need for making some politically painful concessions in agriculture in order to achieve a Uruguay Round success. In the US, also, there are now advocates of regionalism in preference to multilateralism based not necessarily on a view that the former is preferable, but that the latter is (because of European attitudes and possibly Japan's) a lost cause.

Finally, one can see regionalism as a path to multilateralism. This view is just mentioned here, since it is not very plausible. One can imagine (with a great act of imagination) a small number of regional groupings--i.e., FTAs--being formed (e.g., a European, a Western Hemisphere, and an Asian one), and then, the three would negotiate and in one grand bargain open up to each other--and lo, there would be world free trade, or something close to it. This is surely unrealistic.

A more reasonable proposal is the "open club" idea. A free trade area, with the United States at its core, would be established between a limited number of countries--e.g., the NAFTA--but any other country, whether in the Western Hemisphere or outside--would be invited to apply to join. There might be a standard agreement (with the usual safeguards and transition arrangements) which would provide the basis for negotiations with

any new candidate. More and more countries would find it advantageous to join, if only to avoid trade diversion against them, and if they were allowed entry, the FTA would grow and grow until eventually it embraced the whole world. Actually, the European Community has been somewhat like this, though the invitations have been rather limited and applications not always accepted. It is also hard to believe that this process would eventually achieve world free trade, or at least a degree of liberalization and acceptance of international rules equal to what a successful Uruguay Round would achieve. It is more likely to end in a small number of complicated regional arrangements.

(b) Multilateralism and regionalism compared

Let us now consider the interests of a particular LAC and compare the effects of multilateral liberalization with regional liberalization, i.e., an FTA. This comparison is relevant insofar as they are alternatives, and insofar as the LAC can have any influence at all on the extent to which multilateral liberalization takes place.

The first, and main, point is the following. The FTA would open up--or lock-in the opening up--of the US market for the LAC's exports. By contrast, multilateral liberalization would open up and, hopefully, lock-in, the world market. Clearly, from this point of view, the latter is preferable. But a qualification is that the strength of the locking-in effect might be greater in the case of the FTA, in which case the balance might tilt in favor of the FTA.

Second, any agreement, whether an FTA or a multilateral agreement under GATT, involves the continuous enforcement and interpretation of agreed rules, and inevitably negotiations. The bargaining strength of the LAC relative to its trading partners,

and the strength of the rules set up, are then relevant. Here an LAC may be in a weaker situation in an FTA--where the US would be clearly dominant--than in a multilateral environment where none of the three big economic powers (US, European Community and Japan) have the same relative strength, and where more will have to depend on the enforcement of universal rules. Hence, probably, from this point of view, multilateral arrangements are also preferable.

Third, the FTA gives the LAC the benefit of some trade diversion in its favor in the US market--as LAC exports replace exports from outside, e.g., Asia. This has already been mentioned. This effect is not in the US or the general world interest, but it is a benefit to the LAC itself, and thus is an argument favoring the FTA relative to multilateralism. This benefit depends, of course, on the US continuing to impose tariffs, quotas or voluntary export restraints on imports from outside.

Finally, we may consider an LAC government that wishes to liberalize itself but has a problem overcoming domestic pressure groups. It may be able to go a limited way in unilateral liberalization, but beyond that it requires the promise of reciprocal benefits, as provided either by multilateral agreements or by an FTA. The question is which one of these would be politically more persuasive. If the Uruguay Round is successful, LACs should find it in their interests to ratify it, and so they will inevitably undertake certain commitments. But these are likely to be less than in the case of an FTA. On balance, it is probable that an FTA would be more successful in helping along domestic liberalization.

All this discussion of multilateralism versus regionalism is really rather academic. In limited respects Brazil has played a significant role, as has the Cairns Group, which includes some

LACs, but most LACs have little influence on the outcome of the Uruguay Round negotiations. Conceivably, as a group, LAC countries can block agreement, but they cannot change the negotiating positions of the United States or the European Community, the two which have the fate of the Round in their hands.

Countries that are small in the world economy--like all countries in the Western Hemisphere apart from the United States--have a great deal to gain from a new rules-based international trading system. If the choice were between regionalism and multilateralism, the first argument above--that the world market for their exports is better than the US market--and the second argument--that they will be better protected by a rules-based system where there are several large actors, rather than a smaller grouping with one dominant member--must weigh strongly. Multilateralism is best. But that is not a choice to be made. The Uruguay Round may succeed and a sound rules-based system may be established, in which case an FTA might be considered as a supplement, taking into account the many matters discussed in this paper. Alternatively, the Uruguay Round may fail, in which case an FTA should still be considered, and possibly there would be a stronger argument in its favor.

III CONCLUSION

This paper's principal aim has been to lay out the implications for any Latin American country (LAC) of forming a free trade area with the United States. Thus, the emphasis has been on the interests of the LAC--and not the United States or the world as a whole--and it has only been concerned (other than briefly at the end) with the so-called "hub-spoke" case--i.e.,

the case where the hub--the United States--makes bilateral agreements with the various spokes--the LACs.

The analysis has distinguished the liberalization, trade diversion and reciprocity effects, and these have provided a convenient framework for considering all the complex issues involved.

What then, can one conclude?

1. The reciprocity effect is likely to yield the principal gain, and has the potential of being very beneficial. It is surely the main reason why the Initiative has been greatly welcomed in the region. For any LAC the key benefit is to obtain an ensured open market in the United States. Of course, this depends on how open it is already and what threats there are (especially if the Uruguay Round negotiations are not successful) of the market becoming more closed. It has to be noted that, in general, the US market is already very open. The central focus of negotiations must be to ensure that it really is opened up further, that the transition period is not too long, and that there are not too many exemptions, loopholes, and safeguards. This involves numerous detailed considerations that have only been touched upon here but that, for example, play a major role in the current negotiations between Mexico and the United States.

The reciprocity effect is essentially about opening up and keeping open the US market for the LAC's exports. But this paper has noted another aspect, namely, the changes in domestic policies--including subsidies, labor and environmental regulations--that the LAC may be required to undertake as part of an FTA agreement. It has to be considered to what extent they are beneficial. If they are not, the costs have to be subtracted from the main potential reciprocity benefits. On this point also

there are many detailed considerations that have not been discussed here.

2. Coming to the liberalization effects of an FTA, the main point is surely that a country that wishes to liberalize its own trade can do so in any case. And this has been happening. If one accepts the desirability of liberalization--as the writer of this paper does--the question then is simply whether more liberalization can be achieved with an FTA than with unilateral liberalization. Put another way, given that a country carries out unilateral liberalization, possibly to the extent of removing quantitative restrictions on all imports from all sources, and either abolishing all tariffs or leaving them at very low, near uniform, levels (like Chile), can an FTA add anything in this respect?

The answer has to be: possibly not very much. But two points have been made. First, there is the "locking-in" effect. An FTA agreement is likely to lock-in institutionally a part of the liberalization (that which applies to imports from the United States), and so prevent a reversal by a future government. Second, there are other aspects of creating a single market which go beyond removing standard quantitative restrictions and tariffs, and these may be pursued in an FTA, as they have been in the European Community. To conclude with a political economy point, liberalization politically may be easier in some countries when done in the framework of an FTA than when pursued unilaterally.

It must also be added that for a government that does not really believe in the benefits of liberalization, or that, even if it believes in them, finds the domestic political cost very high, the liberalization that would be required by an FTA is pure

cost--possibly a very high cost--to be set against the reciprocity gains.

3. Finally, we come to the trade diversion possibility. It has to be noted again that this refers to trade diversion by the LAC, not trade diversion by the US, the latter being beneficial for the LAC and part of the reciprocity effect. This trade diversion effect is adverse but is only likely to be important if protection relative to outside imports remains high or may become high, possibly in response to shocks of various kinds, to balance-of-payments problems, or to interest group pressures. Of course it may not be possible to resist pressures for higher protection from outside, but if a government has such a "resistance capacity," then it can avoid trade diversion if it wishes.

A judgment is thus needed about the likely future levels of protection relative to imports from outside. If they are likely to be low--as in the case of countries that have recently liberalized unilaterally--the trade diversion effect would not be large, and thus not high enough to offset the gains from reciprocity.

On the basis of an essentially theoretical analysis, one cannot arrive at clear conclusions applicable to any or all LACs. For each country detailed judgments have to be made, and much depends on the outcome of negotiations. As noted at the end of this paper, insofar as a trend towards regionalism diverts interest from or discourages progress in multilateral liberalization, the trend is undesirable for economies that are small and relatively less powerful in the world economy. But one can conceive of FTAs as supplements, rather than alternatives, for multilateral liberalization, and in any case the LACs cannot have a very significant effect on international negotiations.

They have to take the world environment as given.

To summarize, because of the reciprocity effect, LACs are highly likely to benefit from forming FTAs with the United States. They can avoid trade diversion if they wish, and they should welcome the additional domestic liberalization, and assurance of its continuance, that an FTA might bring. Various qualifications to these conclusions have been noted--including the need to change domestic policies to suit US domestic pressure groups, and the possibility that at various times some protection directed against imports from outside may be unavailable (if there are severe adverse shocks on particular industries), and this would then lead to costly trade diversion.

Bibliographic Note

This paper draws on an extensive literature in international trade theory. The pioneering work on customs union theory is Jacob Viner, The Customs Union Issue, Carnegie Endowment for International Peace, New York, 1950. The modern theory of customs unions (which includes preferential arrangements) is surveyed in W.M. Corden, "The Normative Theory of International Trade," in Ronald W. Jones and Peter B. Kenen (eds.), Handbook of International Economics, Vol. I, North-Holland, Amsterdam, 1984. The literature on the theory of protection, analyzing numerous arguments for and against protection, is also reviewed in this survey, and more fully in W.M. Corden, Trade Policy and Economic Welfare, Clarendon Press, Oxford, 1984.