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# The Caribbean countries *and the Free Trade Area* of the Americas

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The Caribbean countries are acutely conscious of their small size, whether judged by one or all of the criteria of land area, population or gross domestic product (GDP). Paradoxically, this impels them to join a larger trading group for fear that they might otherwise be denied a place in the mainstream of international activity. This article analyses several characteristics of small countries, with particular attention to those that seem especially relevant to the Caribbean. The paper notes that small size does indeed place greater demands on the national leadership as regards appropriate and consistent economic management, while the citizens of small countries live at higher levels of risk, whether due to the vagaries of the weather or to the turmoil of international markets. It also recognizes that the range of production options open to such countries is inherently limited and that the transitional costs of entering the Free Trade Area of the Americas (FTAA) might be high, especially as some Caribbean countries have been pursuing policies which run somewhat counter to the new requirements. Emphasis is therefore placed on the lack of preparedness of many small countries for entry into such a market, and proposals are made as to internal and external policy options which might be chosen for this purpose. It is also suggested that, in order to mitigate the short-term transitional costs of entry and enhance their ability to participate in the new grouping, small countries should try in the prior negotiations to secure some transitional arrangements regarding internal policies, measures to increase the production of exportable goods, and joint negotiating strategies.

# I

## Introduction

The Summit of the Americas, held in Miami in December 1994, committed its participants to the establishment, by the year 2005, of a Free Trade Area of the Americas (FTAA) which would seek the progressive elimination of barriers to trade and investment in the Western Hemisphere.<sup>1</sup> The participants agreed to conclude agreements on several issues, such as tariff and non-tariff barriers to trade in goods and services, agriculture, subsidies, investment, intellectual property rights, government procurement, technical barriers to trade, safeguards, rules of origin, anti-dumping and countervailing duties, sanitary and phytosanitary standards and procedures, settlement of disputes, and policy on competition.

The outward-looking character of the Free Trade Area was indicated by the pledge of potential members not to raise trade and investment barriers to non-member countries and to remain committed to the international trade rules and disciplines of the General Agreement on Tariffs and Trade and the World Trade Organization (GATT/WTO). It was stated that the aim of the FTAA was to strengthen the substantial advances already made by the countries of the Americas in the area of trade liberalization and economic integration, which are seen as key factors for sustainable development.

The Summit of the Americas also indicated that trade liberalization and environmental policies were mutually supportive and that workers' rights, as defined by the relevant international conventions, would be promoted and safeguarded. It was also agreed, however, that disguised trade restrictions would be avoided, in accordance with the GATT/WTO agreements. This reference indicated that the FTAA still needed to come to an understanding with regard to the environment and workers' rights as they affect trade liberalization in the hemisphere, since these issues were likely to resurface after the special agreements were concluded.

At the Denver meeting, held on 30 June 1995, a work programme was adopted to prepare for the negotiations leading to the FTAA, which, it was stated, would represent a single undertaking comprising mutual rights and obligations. Several working groups were established to begin work on various specialized issues, including one to make proposals for the effective participation of the smaller economies in the FTAA.

The preparations for the FTAA are taking place in the context of a substantially freer hemispheric and world trading environment. Contributory factors to this environment are the unilateral implementation of trade liberalization policies by many countries, the recent popularity of bilateral and plurilateral free trade arrangements in the region, and the inauguration of the GATT/WTO agreement, which seeks to clarify and strengthen the rules and disciplines governing international trade and investment.

The FTAA covers a large number of potential member countries,<sup>2</sup> which display wide differences in population size, land area, economic structure, resource endowment, level of income, levels of skill and technological development, quality of basic infrastructure and productivity. The differences between the industrial countries and some of the developing countries which are potential members of the proposed grouping are quite stark. Significant differences also exist among the developing countries themselves, which include both large and small economies at different levels of development.

Small size does not of itself represent an inherent economic disadvantage, but it does limit the range of development options available to policy-makers, since small countries have intrinsically open economies which are highly dependent on foreign trade. This means that policies which encourage an efficient

<sup>1</sup> Plan of Action adopted at the Summit of the Americas, held from 9 to 11 December 1994 at Miami, Florida.

<sup>2</sup> Thirty-four countries participated in the Summit: Antigua and Barbuda, Argentina, Bahamas, Barbados, Belize, Bolivia, Brazil, Canada, Chile, Colombia, Costa Rica, Dominica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago, the United States of America, Uruguay and Venezuela.

interaction with the international economy are amply rewarded, while policies which do not are severely penalized. Examples of both types are to be found globally as well as in the Caribbean. Examples of the former include Singapore, Taiwan, Hong Kong or Luxembourg, while in the Caribbean examples can also be found of small countries – some of them very small – which have achieved relatively high standards of living derived from their trade in financial and tourism services. The Bahamas and the Cayman Islands provide two such examples.

Nevertheless, few Caribbean countries have consistently pursued the route of economic openness. Those that have tried to apply import substitution policies behind high tariff walls have not recorded similar levels of economic growth, since expansion has been constrained by chronic shortages of foreign exchange. Export earnings have been sluggish, unresilient to the vagaries of export markets, and in some instances industries have become dependent upon preferences for their survival. These countries must now face a steep adjustment curve, to reverse decades of inappropriate policies, if they are to mitigate the shocks that market openness will have on their economies and benefit from the opportunities which it will eventually confer.

Among the countries of the Caribbean Community (CARICOM), efforts are being made to reform domestic macroeconomic and regional trade policies. However, the rate of domestic macroeconomic policy reform has been uneven as between members, and in some of them regional policies have changed more slowly than domestic policies and have become inconsistent with them. Strains have also become evident as efforts are made by some to quicken the pace of regional trade policy reform, seen for example in attitudes to the pace and degree of reduction of the Common External Tariff (CET) and to the extent of market widening, and also reflected in attitudes toward the Association of Caribbean States (ACS) and the FTAA.

More generally, the small economies display certain characteristics which, although not unique to them, can present special problems in their efforts to achieve economic and social development. For example, they suffer from high unit costs for infrastructure and public administration and experience special difficulties in their macroeconomic management because of the fragility of their economies.

Small economies have a relatively undiversified economic base and rely heavily on exports of a few

primary commodities and services (table 1). For example, in 1994 banana exports accounted for 49.3% of merchandise exports in St. Lucia and 47.9% in Dominica. For Jamaica and Trinidad and Tobago, the dependence on bauxite and petroleum, respectively, was even greater. Consequently, these small countries are particularly vulnerable to fluctuations in the prices and demand for their exports. They also have high levels of imports for both consumption and production purposes which make them vulnerable to changing global supply and prices. Trade in goods exceeds 50% of the product in all cases. If non-factor services are included, the exposure to foreign trade is notably larger, ranging in 1994 from almost 153% of GDP in Antigua and Barbuda to about 62% in Trinidad. Exports, especially in the case of agricultural products, tend to cluster around markets where Caribbean products benefit from preferential treatment. Given the high levels of protection underpinning some of their exports, such dependence on foreign trade illustrates their excessive vulnerability to external shocks, including policy shifts.

The small size of domestic markets prevents firms operating in them from taking advantage of economies of scale or increasing returns to scale in those industries which are scale-sensitive (De Vries, 1984). Conversely, when they attempt to take advantage of such economies they are obliged to capture export markets from the outset, denying them the benefit of enjoying a familiar domestic market in which to perfect their craft. In reality, the industries which have been developed in the Caribbean tend to be highly protected and their production is destined mainly for the domestic market, or for the regional market in the case of CARICOM member countries.<sup>3</sup> The quest for lower tariffs is complicated by the heavy reliance of some countries on trade taxes for their revenues. Import taxes contribute more than half of tax revenues in the OECS countries and Belize, and the proportion is as high as 66% in Antigua and Barbuda. In Barbados, Jamaica and Trinidad and Tobago, where tax reform policies have been implemented, reliance on trade taxes is much less, ranging from about 9% to 14% in 1994. In Grenada, however, early efforts to reform the country's tax regime were set back by difficulties in collecting consumption taxes.

<sup>3</sup> The same levels of protection do not exist in Central America (see Lewis, 1994).

TABLE 1

**Caribbean countries: Selected 1994 indicators**  
(Percentages)

Country	Concentration of exports <sup>a</sup>	Trade in goods/GDP	Goods and non-factor services/GDP	Trade taxes/fiscal revenue	Unemployment rateDJ0
Anguilla	...	55.4	146.9	77.0	...
Antigua and Barbuda	...	75.8	152.6	66.1	5.7
Barbados	23.3	54.8	95.7 <sup>b</sup>	8.6	21.2 <sup>c</sup>
Belize	34.1	79.2	128.0	54.4	9.8
Dominica	47.9	79.3	124.5	56.5	9.9
Grenada	9.3	58.6	99.1	56.9	15.3
Jamaica	78.4 <sup>d</sup>	78.6	101.9 <sup>b</sup>	14.0	15.4 <sup>c</sup>
Montserrat	...	41.5	77.3 <sup>b</sup>	52.5	5.5
Dominican Republic	25.3	32.9	62.7	44.8	...
Saint Kitts and Nevis	40.7	65.2	144.5	55.2	4.7
Saint Lucia	49.3	69.3	113.9	58.7	7.2
Saint Vincent and the Grenadines	29.0	70.0	90.5	50.6	17.9
Suriname	57.4	77.1	92.8	41.7	...
Trinidad and Tobago	75.5 <sup>f</sup>	55.8	61.9	10.4	18.5 <sup>c</sup>

Source: ECLAC, on the basis of official data.

<sup>a</sup> Main exports, as a percentage of total exports of goods.

<sup>b</sup> Income from goods and tourism only.

<sup>c</sup> 1994; other figures are based on most recent data available.

<sup>d</sup> Bauxite and alumina only.

<sup>e</sup> 1993 figures.

<sup>f</sup> Petroleum and petrochemicals only.

The islands of the Caribbean are also prone to natural disasters, such as hurricanes. Given their small size and consequent specialization in a few product groups, a single hurricane could eliminate a substantial portion of their export earnings. In addition, the fragile ecosystems of small island States make them more vulnerable than others to environmental degradation.

The proposed reciprocal opening of markets under the FTAA and the potential consequences thereof present small economies with special challenges, notably the probable elimination of preferential treatment and the consequent increased competition that formerly protected products will face in the hemisphere. Such competition in international markets is sometimes seen as unfair by small economies because they are obliged to compete against more developed countries with higher levels of skill, technology and productivity. Therefore, according to this view, this can only lead to the displacement of their exports and the demise of their import substitution industries. Ironically, arguments are also being advanced in the industrialized countries against the opening of markets to less developed countries. They

fear that low wages and what they deem to be lax environmental and labour standards in the developing countries will lead to the closure of firms, lower wages and higher unemployment in the developed world.

Both the Miami Summit and the Denver Ministerial Meeting recognized the wide disparities in size existing among potential members of the FTAA and pledged to seek ways to provide opportunities to facilitate the integration of the smaller economies and increase their levels of development. Participants were therefore aware of the complex issues surrounding the division of costs and gains in the proposed Free Trade Area, particularly as these relate to the small economies.

This paper tries to clarify some of these issues. It examines some of the measures used by various trade and integration groupings to deal with the question of unequal gains among member countries. It also discusses the potential costs and benefits of participation by the small economies in the FTAA. Finally it suggests some policy actions which might help the smaller countries to adjust to the widening hemispheric market.

## II

### Approaches to the issue of unequal gains in various trade and integration schemes

It is generally accepted in the literature, and supported by experience, that the gains from a trading arrangement are not always equal. Considerable attention has therefore been paid in the various regional trading arrangements to compensating those less able to enjoy the gains from an agreement. In general, while financing arrangements such as special funds seem to provide tangible and lasting benefits, the position is not so clear in the case of differential entry requirements. Nevertheless, the approaches used by the European Union (EU), CARICOM and the North American Free Trade Agreement (NAFTA) are useful as a guide for small countries in their preparations for the FTAA negotiations. It should be noted, however, that the EU is a single market in the process of becoming a political union; CARICOM has elements of both a customs union and a common market; and NAFTA is a free trade area. The different objectives of these levels of integration might result in different approaches by these institutions to the question of unequal gains, although they all illustrate potential courses of action.

#### 1. The treatment of less developed countries in the EU

Two basic mechanisms (concessions) are used to deal with structural diversity within the Union.<sup>4</sup> The first concession is a transitional period to allow a member country to adapt its national legislation and standards to Union levels and practices. This means that sectors considered to be particularly weak in given countries might delay their full exposure to competition from other Union members for several years.<sup>5</sup> The second concession, parallel and often

longer-lasting than the first, relates to the EU Structural Funds Programmes. Although the objective of reducing disparities among regions of the Community was referred to in the very preamble of the Treaty of Rome in 1957, the Funds actually came into being against the backdrop of the Single European Act's statements about "market solidarity" in 1988. They were also prompted by the increase in structural diversity in the Union after its second enlargement, to include Greece, in 1981 and its third enlargement, to include Portugal and Spain, in 1986.<sup>6</sup> In their various forms, the Funds demonstrate a real effort to achieve convergence via efficiency-improving mechanisms, to promote market conditions where they do not exist, and to assist in the provision of public goods in short supply.

#### 2. Treatment of the less developed countries in CARICOM

The principle of special treatment for its Less Developed Country (LDC) members<sup>7</sup> is also well established within CARICOM, where a special regime was created for the LDCs in order to provide them with preferential treatment in the integration process. They were allowed a 10-year adjustment period to implement the Common External Tariff (CET) –double that which was allowed to the More Developed Country (MDC) members– and they were also given a 10-year grace period before being required to engage in free trade

<sup>4</sup> Countries singled out for special treatment are Greece, Ireland, Portugal and Spain.

<sup>5</sup> Specific sectors like banking and finance received "transition periods" of up to seven years in Portugal and Spain. The Common Agricultural Policy (CAP) is also a concession, though with Union-wide application and "permanent" status.

<sup>6</sup> The importance of the Structural Funds can be assessed by their sheer size: 60 billion ECUs (\$US80 billion) for the five-year period 1989-1993. The magnitude of the Funds can also be seen in relation to the economies of the recipient countries, where they represented 2.3% of GDP for Greece, 2.9% for Ireland and 3.5% for Portugal, for the period 1989-1993.

<sup>7</sup> The countries eligible for LDC treatment within CARICOM are Antigua and Barbuda, Belize, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. The MDCs are Barbados, Guyana, Jamaica and Trinidad and Tobago.

with the MDCs of the Community. They were allowed to temporarily suspend the implementation of the CET in order to promote a particular domestic industry, while they were also permitted to suspend common market treatment for imports from the MDCs if major revenue losses were likely to result from such treatment. In addition, the LDCs were given special concessions under the rules of origin, where groups of products which figure prominently in their production, such as processed fruits and galvanized sheets, were granted common market treatment on concessionary terms, whereby the permissible percentage of foreign inputs was set higher than for the MDCs (World Bank, 1990). The LDCs were also allowed to use direct and indirect export subsidies in regional trade in order to favour domestic producers. Finally, the system of harmonized fiscal incentives for investment allowed the LDCs to give investors longer tax holidays and tariff exemptions (usually 15 years, as compared to the 10 years allowed for the MDCs).

### 3. The treatment of Mexico in NAFTA

Despite the principles of reciprocity under which NAFTA was negotiated, Mexico was able to negotiate differential treatment in selected areas. For example, differential phasing periods were agreed in order to protect Mexico from surges in imports from its more developed partners. The agreement stipulated that the

proportion of Mexican imports entering duty free would only represent 43% of its non-petroleum imports from the United States and 41% of the corresponding imports from Canada.<sup>8</sup> However, it was agreed that 84% of Mexico's total non-petroleum exports to the United States and 79% of those exports to Canada would benefit from duty free entry, with effect from January 1994.

In the case of textiles, it was agreed that the United States would begin by eliminating tariffs on 45% of its imports from Mexico, while Mexico need only eliminate tariffs on 20% of its textile imports from the United States. Concessions were also negotiated by Mexico with regard to the automotive sector, where approximately 81% of the value of Mexico's exports of parts to the United States would enter duty free upon the coming into effect of the NAFTA, while only 5% of United States exports of parts and components to Mexico would enter on similar terms. With regard to agriculture, it was agreed that the United States would remove tariffs on products amounting to 61% of the value of agricultural imports from Mexico, while Mexico would be expected to remove tariffs on products amounting to only 36% of the value of its agricultural imports from the United States (Sera Puche, 1992). Nevertheless, these concessions were intended to be temporary, and the agreement included a time-limit during which liberalization of trade in all sectors would take place.

## III

### Potential benefits of market opening

It is widely recognized, though not universally accepted, that free trade improves efficiency and welfare. Simply stated, the argument is that foreign trade permits a country to specialize in doing the things it can do most productively, maximizing its earnings by exchanging a portion of its production. Imports, in turn, free a country from having to produce all the goods and services necessary for its survival, many of which it would be physically incapable of producing, while most of the remainder it could only produce at very high cost. With free trade, domestic production can concentrate on the most efficient activities, while the remaining national needs can be satisfied by the foreign countries that produce the goods

most competitively. Welfare is therefore maximized by trade, since all parties benefit. While this argument evolved in the developed countries, it is even more germane to the small and less developed nations, since they stand to benefit most from trade. Nevertheless, small countries have a relatively greater need for secure market access and stable and transparent trade rules, if they are to be able to trade effectively.

<sup>8</sup> These percentages are based on the value of trade in 1991.



It was in recognition of these principles that GATT was formed, in order to encourage the development of multilateral trade and to define and administer the rules which should govern it. This mantle has now been assumed by its successor organization, the WTO. Several regional trading arrangements have been spawned since the establishment of GATT. While they diverged from pure multilateral principles, they were usually accepted as a second-best option by GATT.<sup>9</sup> This acceptance came in part because regional trading arrangements had the potential to move member countries more quickly toward the goal of multilateralism than might have been possible by unilateral action. The FTAA also holds this potential, since it could establish a free-trade area encompassing most of the trade in goods and services for most of the countries in the hemisphere. The alternative –unilaterally achieving the same degree of trade liberalization via GATT– is less likely to be realized, given current attitudes. This is especially true for the smaller countries, since small clusters of them have long-standing commitments to limited trading arrangements among themselves. Moreover, the principles and attendant risks of multilateral trade are not embraced by all of them.

Trade liberalization is currently being reintroduced by some of the Caribbean countries which experienced the most severe economic disequilibria in the 1980s. For them, as for all small economies, export earnings play a pivotal role in their economic expansion, and increased earnings became especially critical if they were to meet their outstanding external debt obligations. Supporting evidence for this proposition was provided by the success of some other small countries which were successful in achieving export-led growth.<sup>10</sup> Improved export performance was seen as the way to establish equilibrium and achieve sustained growth. Policies to favour the production of tradeable goods and services in preference

to non-tradeables were applied, beginning with measures to increase economic efficiency and reduce the various policy biases against export activities. These measures began with restrictive fiscal and monetary policies and realignments of the real exchange rate. Subsequently, exchange rate regimes were often modified to ensure that the market would play a greater role in determining rates than hitherto, in the hope of avoiding the gross misalignments which had developed when rates were administratively fixed. Once domestic demand was contained, these governments felt sufficiently confident to focus on various medium-term policies, such as foreign investment codes and deregulation of the financial system. Labour market policies have not yet been approached in any systematic manner, although this seems warranted in view of the chronically high rates of unemployment in some countries. Nevertheless, dialogue between management and the trade unions has led to improved communication between the social partners.

Attention was also given to the trade regime, with emphasis on elimination of the remaining anti-export biases inherent in the tariff structure and the administrative arrangements governing trade. But the pace of domestic reform was uneven in some cases, since existing integration policies, based on a consensus, habitually inhibited the pace of change in those areas covered by common regional positions. In several instances trade policies lagged behind other domestic macroeconomic policies and created tensions with them. Undertakings were frequently ignored or implemented tardily, so that frustrations developed within the regional grouping among those wishing to push ahead with economic reform.

Entry as a group into the wider FTAA would probably be a more feasible means of reducing trade barriers among the small countries.<sup>11</sup> It has the benefit of providing some continuity with past policies and would permit the maintenance of soli-

<sup>9</sup> Article XXIV of the General Agreement outlines the conditions under which integration is deemed not to be in breach of the GATT regulations. Efforts were subsequently made, leading up to the WTO, to define these conditions more precisely.

<sup>10</sup> Notably in Asia, where trade liberalization was pursued in a non-discriminatory manner, rather than through regional trading schemes. Accordingly, the countries which followed this approach avoided the worst faults of Import Substituting Industrialization, which at best had only very limited utility within small market areas.

<sup>11</sup> For many, the creation of the Association of Caribbean States (ACS) is seen as a way station to the wider hemispheric market, originally via NAFTA, more recently via the FTAA. Although the timing might make it difficult, the ACS could still provide the means by which countries could unify their policies, build negotiating power and get accustomed to competition in the larger group of Caribbean countries, prior to full incorporation into the wider hemispheric agreement.

parity among the existing membership and the retention of some of the security which the existing arrangements are believed to confer. It is also seen as a means of extending the policy scope available to those seeking to maximize economic efficiency and the export thrust. At the same time, widening increases the market size, which is deemed to be necessary by some if the export thrust is to be successful.

Greater market access is seen to be desirable because the CARICOM market is inherently small and further constricted by the demand management policies needed in order to sustain equilibrium in the face of sluggish export performance. Increased market size, in conjunction with uniformly low tariff rates and liberal rules of origin, will reduce the incidence of trade diversion and provide economies of scale. Widened market access, within the context of a formal agreement such as the FTAA, is likely to reduce uncertainty in connection with the regulations governing trade in goods and services and to yield transparent mechanisms for dispute settlement. These are all factors of enormous benefit to small countries which do not have market power to bolster them in trade disputes.<sup>12</sup> Finally, for a small country facing the risk of domestic policy reversals, binding the policy fundamentals in the framework of a multilateral arrangement can have the benefit of increasing policy consistency. Trade liberalization, which has been resisted in some Caribbean countries, could therefore be reinforced or accelerated as a result of participation in the FTAA.

The payoff—to be derived from increased economies of scale, greater market security and transparency, and greater policy consistency, taken together with those market liberalization measures which have already commenced unilaterally—is likely to come in the form of increased domestic and external investment and technology transfer for enterprises in the export sector. At the same time, in view of its low tariff rates and its large market size, an arrangement such as the FTAA is unlikely to inhibit global market penetration, where such potential exists for small countries. For the medium to long term, the FTAA holds the potential for increased economic growth, employment and social equity.

<sup>12</sup> For example, the Omnibus Trade and Competitiveness Act of 1988 is used by the United States to decide unilaterally and apply, or threaten to apply, trade sanctions against those countries it regards as unfair traders.

The initiative to consolidate a single market within CARICOM might come under some pressure from efforts to enter the FTAA, since Caribbean governments have decided to pursue both initiatives simultaneously. One justification for the single CARICOM market is the infant industry argument: i.e., the argument that the protected market will stimulate investment in larger and more efficient enterprises for the production of goods and services, eventually making the region better able to penetrate the wider ACS and FTAA markets. Set against this position is the fact that entry into the FTAA will require a fairly large reduction in the prevailing CARICOM tariffs, which, to be manageable, should be phased gradually and begin early. There are therefore evident inconsistencies between the infant industry argument and the need for a smooth transition to the wider market. From a more practical viewpoint, the relative pace of convergence to the single market is currently so slow that it might not come into effect sufficiently quickly to allow this expectation to be fulfilled. Participants are therefore likely to experience some difficulty, in the single market under still high tariffs, in developing proficiency in production fast enough to take advantage of market opening. Finally, the argument for protection tends to ignore its corollary: the anti-export biases handicapping new industries which must enter competitive markets. For these reasons, rapid downward revision of the CET should not be held hostage to the creation of the single market.

The second argument is that a single consolidated market of the factors of production broadens the frontier of production possibilities. Broad agreement has been reached to reduce impediments to the flow of capital and certain categories of skilled labour in the single market, but national legislation to give effect to these decisions has been slow in forthcoming. Both activities are likely to have long-term benefits for the region, and will not be negated or reduced by the hoped-for increase in extraregional investment to be derived from market widening. This benefit is likely to be felt whether or not tariffs remain high, so it is not in any way inconsistent with market widening.

The third argument in favour of deepening CARICOM integration is the greater coordination of external policies that this would imply. One expectation would be joint negotiation to enter the FTAA as a group. In one sense this could be advantageous to

CARICOM, since it would better preserve the integrity of the group<sup>13</sup> and allow for the joint resolution of issues of common concern. It would also simplify the negotiations for all parties if the total CARICOM membership negotiated as if it were one entity. To be weighed against these benefits is the risk that

the uneven pace of economic reform within CARICOM might complicate its internal preparations for the negotiations and jeopardize the chances of entry of the whole group, unless rapid progress can be made on the major potential stumbling blocks, notably the CET.

## IV

### Potential costs of market opening

The fears expressed by smaller, less developed economies about their integration into larger economic areas fall into two broad categories: economic and political. On the political side, nations fear the loss of sovereignty implied by any international commitment having domestic repercussions. Smaller nations, which often are newly independent, fear this the most, since they are acutely conscious of their weak bargaining power. Yet as international transactions proliferate, some loss of sovereignty is virtually inevitable for all countries. One answer to the concern of limited bargaining power might be for the smaller nations to conduct their negotiations on the basis of a regional bloc, although this strategy also involves some loss of sovereignty. On the other hand, their small size might permit them to obtain concessions that larger nations dare not seek.

The political question of reduced sovereignty may also have economic implications, even in seemingly straightforward commitments. For example, a report on NAFTA notes that a country seeking to enter into a free trade agreement with the US must undertake to maintain a stable macroeconomic environment.<sup>14</sup> This requirement implies a limit on the application of counter-cyclical policies favoured by some governments, even without explicit and strict benchmarks such as those set by the European Union's convergence criteria. Similarly, the Supplemental Agreements of NAFTA, especially those covering labour practices and environmental standards, can affect the relative attractiveness of some countries for investment and entail significant costs in their application in small countries.

On the economic side, small countries are mainly concerned with the potential losses from the exposure of their domestic industries to foreign competition and with the costs of adjustment to the widened market. This is particularly true of those Caribbean and Central American countries currently operating within common market arrangements. The traditional economic literature is more concerned with the gains derived from market opening than with the losses. These gains are generated by an increase in the efficiency of resource allocation, which generates both higher output and a higher level of welfare. Nevertheless, the costs of transition are real and need to be borne in mind.

Potential losses are usually considered to be limited to the short run, since some factors of production, such as workers trained to perform distinctive tasks or factories built to produce unique goods, are specific. Specific production factors are those linked to a given production process that can be rendered uncompetitive by the opening up of an economy and are not easily or immediately transferrable to other uses. In the long run, however, all productive factors are assumed eventually to adjust to market signals, that is, they find alternative adequate uses, resulting in an optimal, equilibrium configuration. This argument recognizes that there are always relatively competitive sectors, for in the framework of the Ricardian Comparative Advantage theory, while it is possible for a country to be less competitive in all sectors in absolute terms, it is impossible for any country to be relatively uncompetitive in all of them. Therefore, even where all sectors are absolutely less competitive than the global best, all the domestic agents are potential winners from trade, since the relatively more competitive sectors can generate the resources to compensate the potential losses of

<sup>13</sup> To pursue the range of beneficial activities in areas other than trade that will remain after entry to the FTAA.

<sup>14</sup> See *Report on the North American Free Trade Agreement*, Vols. I and II (G.S.R. Associates, Port of Spain, Trinidad, 1994).

relatively less competitive sectors through various transfer schemes.<sup>15</sup>

When analyzing the trade effects of economic integration, economists usually consider three categories: trade creation, trade diversion and gross trade effects. Trade creation is defined as the development of new trade flows among members of the new economic area that displace previous high-cost domestic production, while trade diversion is the substitution of low-cost imports from third countries with high-cost imports from member countries. Gross trade effects are the result of the two, and represent the net trade effect of the preferential trading area on itself and on the rest of the world.<sup>16</sup> From the point of view of global welfare, any integration short of global integration is sub-optimal.

So far, there are few estimates of the concrete effects of NAFTA on the smaller economies. One estimate finds that the new market conditions offered to the Mexican textile producers had no negative effect on the Central American textile sector. Negative effects did arise, however, from the competition between Central American countries in an export-oriented sector with homogeneous products and a high substitution elasticity. In this particular case, the net trade effect was zero for these economies outside the trade bloc.<sup>17</sup>

Another study, quoting estimates from a World Bank report, forecast some limited static and dynamic losses from NAFTA non-membership for the CARICOM countries. The static losses were concentrated in certain countries and sectors, for example, Jamaica and the clothing, apparel and footwear sectors. Most of the NAFTA effects, however, appeared in the dynamic estimations (those incorporating the long-term effects of increased market scale and efficiency of allocation), which projected a clear

reduction of growth rates for all Caribbean countries outside the unified trade area (McIntyre, 1994).

As a first approximation, we may assume that the less competitive industrial sectors developed under the import substitution, high-tariff strategy would suffer the most in the short to medium term from external competition. The same could be said about protected agricultural sectors. However, it is likely that protective tariff structures will be gradually dismantled as a consequence of GATT/WTO initiatives.

Conclusions with respect to the services sector are somewhat less clear. The tourism industry is already relatively open and competitive, although some ancillary services in the industry could be vulnerable to external competition.<sup>18</sup> Opening the financial sector could also mean the displacement of some domestic firms, or at least trigger some form of association with foreign enterprises.<sup>19</sup> Telecommunications facilities in most countries are either foreign-owned or operated as joint ventures with foreign companies. Nevertheless, in the telecommunications sector (which has a tendency towards monopoly, especially in small countries), as well as in the financial services sector, new entrants to the market might increase efficiency and the pace of technological change. Finally, it should be noted that services were also partially covered by the Uruguay Round of GATT negotiations and are likely to undergo further liberalization waves through the WTO.

Additional concerns might also arise from: i) the fiscal importance of import taxes in some countries in the region, since any harmonization process that changed tariffs significantly could mean short-term budgetary difficulties and/or the need for concomitant tax reform measures; ii) a conflict with existing preferential structures, the most quoted but by no means the only examples being the incompatibility of the Lomé Convention or the Caribbean Basin Initia-

<sup>15</sup> The classical exception to this is the famous case of "Immiserizing Growth", developed by Bhagwati in his 1958 paper. This is today considered to be a largely theoretical possibility. See Krugman and Obstfeld, 1988.

<sup>16</sup> See Markheim, 1994, who calculates that the net trade effect of integration on US imports from the Caribbean between 1987 and 1993 was 99.9%: i.e., almost the entire increase was created by CBI preferences.

<sup>17</sup> This means that those countries could probably remain competitive in the sector in the short run, but once one of them entered the preferential trade area unilaterally, the outsiders would all be losers. The optimal game strategy would be for them to negotiate and enter as a regional bloc. See ECLAC, 1995.

<sup>18</sup> However, major changes in national market shares are likely to result from the full integration of Cuba into the region's tourism industry.

<sup>19</sup> Economies of scale are usually considered to be less important in the financial sector, where the existence of a widespread network of branches and local knowledge of domestic market conditions act as an entry barrier against major external competitors. Nevertheless, small domestic financial markets suggest a relatively small fixed investment in the network, while increasing interest in overseas operations could reduce the relative importance of domestic market knowledge.

tive (CBI) with a hemispheric free trade area, although once again these structures are already under question due to EU developments and aforementioned GATT/WTO commitments; iii) the costs related to the regularization of patent and copyright situations, which could entail increased financial transfers abroad and loss of freedom for domestic agents wishing to establish new businesses, although this too is a question that will be addressed on a global scale through GATT/WTO; and iv) the financial and human cost of administering any integration organization, although this is expected to be relatively light in the case of the FTAA.<sup>20</sup>

In short, there are some legitimate concerns among the smaller, less developed nations regarding short-run losses from a hemispheric integration process, but most of these losses would occur anyway, since they are being driven by historical factors of a political, economic and technological nature which are impinging on all countries. While the FTAA will probably accentuate these trends, the real issue facing the smaller countries is how to secure transitional arrangements to cushion them from its greatest shocks, so as to enable them to implement the measures needed to improve their effectiveness within the group.

## V

### Policy proposals

The Denver trade ministerial meeting, in its final declaration, recognized the special concerns of the small countries and agreed "...to actively look for ways to provide opportunities to facilitate the integration of the smaller economies and increase their level of development." The Summit further mandated that the factors affecting the participation of the smaller countries in the FTAA process should be identified.<sup>21</sup> These included measures to facilitate their adjustment, trade expansion and investment, and measures to be taken to facilitate their negotiating capacity. Any other issues of special interest to the smaller countries were also to be identified so that they could be taken into account in the negotiations.

Many of the smaller countries currently enjoy preferential trading arrangements which bolster their economies but at the same time inhibit the adjustment processes necessary for their effective incorporation into a wider free trade arrangement. This is particularly true of the traditional agricultural exports, notably bananas and sugar, but it also applies to some segments of the garment industry and most of the light manufactures and agro-industrial goods produced for the regional market. In most of the smaller countries the cumulative effect of these preferences is to severely distort their production and consumption patterns. Efforts have nevertheless been made to push the adjustment process forward, including the lowering of the Common External Tariff, and

some of these distortions are being reduced. However, where individual preferences loom large in the economy, the underlying macroeconomic picture may be so distorted that countries are able to postpone action on the adjustment of real exchange rates and measures to stimulate investment in unprotected exportables. At the same time, the ephemeral benefits of protection can be so great for the economy and social fabric that policy attention focusses on lobbying for their retention rather than on adjustment.

One way out of this vicious circle is to decouple the financial benefits derived from, say, banana protection from those of banana production. This might be possible if the preferences, which have a finite life, could be phased out progressively, for example over a five-year period, with the amount of preference reduced each year being transferred to an investment fund. This fund might be used for improving the efficiency of the protected industry or for investment in other exportables. Such reduction in the level of preference would encourage the least

<sup>20</sup> For example, the EU is financed by all its Member States from a portion of their Value Added Tax (VAT) and import duties, up to the equivalent of 1.21% of the Union's combined GDP for 1993. Most of these resources go to the Common Agricultural Policy (CAP) and Structural Funds programmes.

<sup>21</sup> Final joint declaration of the Summit of the Americas trade ministerial meeting (Denver, Colorado, 30 June 1995).

productive to begin to switch production immediately, while the reduced export earnings from the preference could be allocated for investment in other exportables. Even so, this mechanism might still create some distortions in the economy, and caution would be needed to ensure that adjustment measures were pushed ahead and that greater attention were paid to the real exchange rate and other measures designed to encourage a positive investment climate. Where the protection was internally derived, say within a common market arrangement, some form of assistance (including help in tax reform where necessary) might be provided which would be conditional on the more rapid reduction of those preferences deemed to be excessively high.

More generally, levels of protection might be so high and the capacity to respond to changes so low in the smaller countries that they might require a longer time to adjust than the more developed or larger countries of the hemisphere. Even in such cases, it would be important to select benefits that would not inhibit but rather encourage adjustment. This should always take the form of fairly rapidly phased reductions in protection, though with lengthened periods of supplemental assistance. Lengthened periods of assistance are always preferable to lengthened periods with high preferential rates, since the evidence clearly shows that protection prevents adjustment and encourages an anti-export bias, whereas financial incentives can be used to facilitate a transition. Aside from funds for investment, assistance might take the form of funds earmarked for improved basic education; strengthened skills training, especially directed to young people; promotion of business skills and entrepreneurial development; and retraining and other forms of support to assist workers from displaced industries to find new employment.

Small countries inherently suffer from supply constraints and, as outlined above, past incentives to production have for the most part resulted in expensive and inappropriate outputs. The first priority is therefore for new investment and production in tradeables. Nevertheless, instances of exportable and potentially exportable production will still need initial assistance in marketing to take advantage of the new enlarged trade zone. This assistance might take various forms, from private sector trade corporations to represent a range of small country products in major markets, to measures designed to stimulate in-

vestment, including investment in joint production/marketing ventures.

The issues of the environment and workers' rights are also of special importance to the small countries. However, they should not be used to impose disproportionate burdens on their production or to erect barriers to their exports. The low barriers to trade and the higher levels of economic efficiency which the FTAA is likely to bring about will help many small countries to obtain the resources and gain access to the technology they need in order to improve their environment. They are also likely to stimulate investment and employment, thereby improving the rights of a large percentage of the labour force currently unemployed. This would make a major contribution to increasing social equity. While it is recognized that the unregulated market might not be sufficient to meet all the goals relating to the environment and workers' rights, the fullest use should nevertheless be made of the wider multilateral institutions specially charged with resolving these issues.

Finally, a major limitation affecting small countries is their limited capacity to negotiate effectively in the run-up to a complex international treaty. Public sectors are small and skilled manpower scarce, so that where detailed negotiations are being conducted, especially in simultaneous working committees, some interests might fall by the wayside or resources might be spread too thin to be effective. One solution to this logistic problem, which has demonstrated its utility in the past, is for small countries to join together to form joint negotiating teams and to engage consultants jointly under the auspices of some common institution. Another solution could be to encourage private actors to help define and, in appropriate instances, defend their interests.

Several initiatives could therefore be taken to improve the participation of small countries in the FTAA. These might include all or a combination of the following measures:

i) The introduction or, where action has already been initiated, the acceleration of domestic policies designed to increase the resilience of small economies, to make them more responsive to external developments, and to allow domestic firms to be more competitive in external markets.

ii) The harmonization or acceleration of policies, as the case may be, within their respective integration

arrangements in order to make them more consistent with the domestic policy objectives outlined above.

iii) Given the vulnerability of some small States and their relatively poor state of preparedness to face greatly expanded competition, they might seek phased conditions for their entry into the widened market, so as to offer local producers a longer period of adaptation and reconversion. These concessions should be finite and limited in duration, so as to increase the urgency of action. They should also be gradual, so that shocks can be effectively absorbed and the economies progressively strengthened to confront them.

iv) In view of the extent to which some small countries still depend on protectionism, funding might be sought, in the context of an accelerated phase-out of preferences, to increase where possible the productivity of traditional exports or to stimulate alternative exportable products.

v) Since small countries face high unit costs in providing basic infrastructure, including public services, special funding might be sought to finance activities that will improve productivity across the economy as a whole: for example, to upgrade the

economic infrastructure and improve skills training and basic education.

vi) Assistance could also be sought, from the countries with the largest markets, to help small countries increase investment in exportables, to foster joint ventures or production-sharing arrangements, and to develop arrangements for marketing their exports.

vii) In view of the limited production possibilities of small countries, liberal and flexible rules of origin should be available to them so as to encourage the production and trading of goods and services.

viii) Small States might also benefit by constituting themselves into a joint negotiating group to define and agree upon their common core interests, plan their strategies, carefully prepare their negotiating positions and engage in joint negotiations to secure their common interests.

ix) The private sector should be integrally involved in the preparations and negotiations for the FTAA, since all the measures which will be applied to expand exportable supplies –the essential condition for effective participation in wider markets– will depend upon their commitment and expertise for success.

## VI

### Summary and conclusions

Small Caribbean countries face a fairly steep adjustment curve to prepare themselves for entry into the FTAA. The task is complicated by their own uncertainties about their capacity to compete on global markets: uncertainties fuelled mainly by their perception of the handicaps due to their small size. The task is further complicated because some countries need to adopt policies which go counter to practices accepted over the past three decades. Finally, action is also inhibited because the costs of adjustment are likely to be felt immediately, in the short run, while the benefits are likely to appear only in the medium to longer term.

Caribbean economies have traditionally been closely integrated into the global economy. This is not surprising, since they are small and must rely on outside purchases to satisfy the majority of national needs. Past policies, which have attempted to attenuate this external dependence, have been counterpro-

ductive. They have so distorted production structures and damaged export performance that, in some countries, global interaction has only been sustained via preferential trading arrangements. The increasing globalization taking place through GATT/WTO suggests that preferential arrangements will be gradually dismantled. Parallel developments taking place regionally –notably the formation of larger trading groups– also require that barriers to trade in goods and services, financial flows and technology should be brought down within the group. At all events, the pressures to open Caribbean markets will be intense. Several countries have anticipated these trends and initiated a process of market liberalization.

The preparations to enter the FTAA are consistent with actions which Caribbean countries would need to take to integrate efficiently into the wider global markets. The process leading up to entry into the FTAA holds out the prospect that small Caribbean

countries can negotiate a systematic set of measures, timetables and safeguards to assist their adjustment. Access to a clearly defined larger market should help to remove some of the policy and market uncertainties which potential investors now face, thus quickening the pace of the investment needed to transform these economies. This process gives small countries the chance to improve their preparedness in a climate of somewhat reduced risk.

Since the smaller countries are less well prepared and are therefore likely to experience some difficulty in taking advantage of the potential benefits of the FTAA, they should organize transitional arrangements to help mitigate the short-term costs of entry. These should focus on three categories of action: internal policies; measures to increase the production of exportables; and joint negotiating strategies. In the first category, more liberal timetables should be sought so that domestic policies and, where relevant, policies within trade groupings could

adapt to the requirements of the FTAA. Special funding should also be negotiated as a substitute for the current export preferences, so as to provide an effective transition away from them. In order to increase the production of exportables, a development fund should be established to improve economy-wide efficiency in areas such as infrastructure and training. Small countries should also seek assistance to develop joint ventures, production sharing arrangements and marketing skills, and they should also try to obtain more liberal rules of origin, given their limited production possibilities and the importance of obtaining the most cost-effective production inputs. Finally, they should strengthen their negotiating positions by forming joint negotiating teams, which should include persons having a direct interest as well as representatives from the productive sectors who possess special expertise in the areas under discussion.

(Original: English)

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