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Open regionalism *and economic* integration

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Economic integration in Latin America has entered upon a new stage, conditioned by new development strategies undertaken mostly by democratically elected governments, and directed at adjusting to a changed and increasingly demanding world economy, while attempting simultaneously to increase the Latin American countries' competitiveness. In the first section of this paper, the "stylized facts" of this new stage of economic integration are briefly reviewed, after which an explanation is given, in section II, of the main determinants of the significant growth of reciprocal trade and investment flows within the region that has taken place in the 1990s. Section III then explores the meaning of "Open Regionalism", a proposal put forward by ECLAC regarding economic integration in the region in the present circumstances. In the final section of the article, some of the obstacles likely to be faced by economic integration in the future are identified.

I

The stylized facts of economic integration in Latin America

There are two phenomena which characterize the process of economic integration in the 1990s: first, the proliferation of free trade agreements, especially at the bilateral level; second, the significant expansion of reciprocal trade and investment within the region.

1. Characteristics of recent integration agreements

With regard to the first aspect, at least ten bilateral free trade agreements have been signed between 1990 and 1993, in addition to 14 more that were signed between 1982 and 1990 (ECLAC, 1994, table II-5). Of these, Chile has been a partner in four and Argentina in three. Additionally, MERCOSUR (the Common Market of the South)—an integration agreement which includes Argentina, Brazil, Paraguay and Uruguay—was formed in 1991.¹ All these agreements share five characteristics.

First, the coverage of the new agreements of the 1990s in terms of liberalization, though still limited, tends to be greater than in the past. Specifically, only four out of the ten new bilateral treaties concluded between 1990 and 1993 have “negative” lists of products excluded from free trade, whereas the remaining six have more restrictive “positive” lists referring to the products which benefit from free trade. Nevertheless, this compares favourably to the recent past, since only one out of 14 bilateral free trade agreements signed during the 1980s had a negative list. Moreover, MERCOSUR includes a commitment to gradually eliminate all exceptions included in its negative lists.

Second, more recent agreements involve greater preferential tariff reductions than in the past. Whereas in the past tariff reductions were often of a partial nature, current preferences normally involve the complete elimination of tariffs.

Third, restrictive sectoral agreements are no longer very prominent, with the notable exception of automobiles. This involves a significant departure compared to the older integration agreements such as the Central American Common Market and especially the Andean Group, which included industrial programming efforts at a subregional level. There is, however, a danger that different national or regional content requirements (rules of origin) may become an increasingly important source of sectoral selectivity, through the establishment of conditions which in fact limit the expansion of trade.

Fourth, services are not usually covered by these agreements, with the partial exception of maritime and air transport. Most agreements still involve “shallow” rather than “deep” integration, that is, they refer almost exclusively to trade in goods. However, there is a growing number of agreements which include clauses on reciprocal investment, granting most favoured nation or national treatment to investment originating in partner countries. Since trade in services often involves foreign investment, these clauses in fact favour reciprocal trade in services.

Finally, the building or renewal of common institutions has not, in general, been part of this new wave of integration. Even though there has been a proliferation of agreements—including some ambitious ones like MERCOSUR—, a common trait has been the reluctance of governments to create new permanent supranational institutions in charge of promoting or monitoring integration agreements. This would appear to be due to greater informal contact between various actors (government officials, political parties, NGOs and enterprises) at a regional level, as well as greater realism concerning the role of institutions. More specifically, the greater skepticism concerning regional institutions would appear to reflect certain

□ This article is based on a presentation made at the conference “Latin America and the international economic system in the 1990s: macroeconomic adjustments and their alternatives”, McGill University, Montreal, Canada, April 1994.

¹ More general integration commitments, including the association of groups of countries (Central America and Mexico, CARICOM and Venezuela, as well as the Group of Three formed by Colombia, Mexico and Venezuela) have also been signed.

frustration with regional institutions in the past, as well as the need to avoid premature institutionalization of a process of integration which is still in a state of flux.

2. The expansion of intraregional trade and investment

Together with the increase in the number of integration agreements, there has been a significant expansion of intraregional trade and investment. Intraregional exports as a proportion of total exports grew from approximately 11% in 1990 to about 17% in 1992 in the case of most of Latin America (i.e. the member countries of the Latin American Integration Association (ALADI). This proportion increased from 14% to 20% in Central America, and it remained constant only in the Caribbean. Most intraregional

exports consist of industrial products, but agricultural products traded within the region also increased significantly between 1985 and 1991/92, as a proportion of total agricultural exports (ECLAC, 1994, table II-2).

Although information on intraregional investment is hard to come by, there is some evidence that it has increased significantly, shifting from the short-term capital flows of the past to more permanent direct investment at present, and including a growing proportion of regional foreign investment in services (ECLAC, 1994). There are also indications of a gradual process of rationalization of activities of subsidiaries of transnational enterprises, as they gradually adopt subregional or regional goals and perspectives instead of their older national approach that resulted from producing for relatively closed national markets in which an import substitution strategy had made itself felt.

II

The reasons for greater economic interdependence

The contribution of integration agreements, particularly of bilateral ones, to the expansion of intraregional trade and investment is not very clear. First, most bilateral agreements continue to be based on positive lists, in which reciprocal free trade is granted to only a limited number of products, thereby limiting the coverage of products subject to liberalized trade. Second, many pairs of countries without bilateral free trade agreements have experienced very high growth rates of bilateral trade: higher than between other countries which had integration agreements. For instance, in 1992 Brazil and Colombia, Brazil and Mexico, and Mexico and Venezuela experienced higher growth rates of reciprocal trade than many other pairs of countries which had signed bilateral or subregional integration agreements (ECLAC 1994).

A closer evaluation of trade patterns in the region leads to the identification of other, possibly complementary, explanations of the significant expansion of intraregional trade. First, the region's total imports have grown dramatically, increasing from less than US\$100 billion in 1990 to almost US\$150

billion in 1993. Second, this significant increase in imports can be attributed to lower levels of protection, stabilized economies which are experiencing signs of reactivation and, in an increasing number of cases, appreciating exchange rates. Intraregional trade has grown as part of this phenomenon. Significantly, intraregional imports as a proportion of total imports have not increased when taking the countries as a whole: they accounted for approximately 16% of ALADI members' total imports in 1990 but only about 14% four years later, in 1993.

Specifically, the growth of intraregional trade can be associated with more or less simultaneous unilateral liberalization processes. This has also allowed geographical proximity to become an important determinant of trade flows. Thus, neighbouring countries which have proceeded with unilateral liberalization, sometimes reinforced by integration agreements, have become major poles of dynamic intraregional trade expansion. These poles include Argentina and Chile, Brazil and Argentina, Colombia and Venezuela and El Salvador and Guatemala.

Furthermore, in addition to privatization, especially in the telecommunications and transport sectors (Devlin, 1993), most countries in the region have gradually reduced the number of sectors reserved for the State and for national investors, and adopted rules that do not discriminate against foreign investors (Calderón, 1993). And just as unilateral liberalization has contributed to intraregional trade expansion, deregulation and privatization has contributed to greater intraregional

flows of investment, especially in services, where not only geographical proximity but also cultural affinity are important explanatory variables of these flows (United Nations, 1993). In addition to these factors, the process of economic restructuring in Latin America and the growing globalization of some of the most successful firms in the region has meant that they have begun to invest abroad, both in Latin America and beyond (Peres, 1993).

III

Towards open regionalism

Two phenomena would therefore appear to be promoting integration in Latin America. On the one hand, unilateral liberalization, deregulation and stabilization have created conditions which "naturally" or spontaneously favour greater economic interdependence between countries which share a geographical space and certain cultural characteristics. On the other hand, there are additional policies, of a preferential nature, which can further strengthen interdependence. Open Regionalism consists in strengthening the links between both elements, that is, between de-facto integration and policy-driven integration, in such a way as to enhance the competitiveness of the countries of the region and, in so far as possible, constitute a building block for a more open and transparent international economy (ECLAC, 1994).

For integration agreements to be consistent with Open Regionalism, they should meet the following requirements (ECLAC, 1994):

- i) Provide for the extensive liberalization of markets in terms of sectors, including both goods and services, though without excluding different transition periods to allow for gradual adjustment;
- ii) Involve broad liberalization of markets in terms of countries, which means that the entry of new members should be facilitated, especially in the case of important ("natural") trading partners;
- iii) Be governed by stable, transparent rules, favouring those trade rules which are GATT-consistent and harmonizing standards in accordance with international agreements;

iv) Be adopted between countries which have managed to stabilize their economies, while strengthening regional institutions that provide balance of payments financing in order to minimize possibilities of macroeconomic disequilibria;

v) Apply moderate levels of protection against third-party competitors and favour the use of common external tariffs, phased in gradually if necessary;

vi) Eliminate or harmonize institutional arrangements (regulations, norms), facilitate the convertibility of currencies or adequate payments arrangements, and build infrastructure, all in such a way as to minimize transaction costs both within and between countries;

vii) Adopt flexible and open sectoral agreements which will favour the international transfer of technology;

viii) Include special measures to favour the adjustment of the relatively less developed countries or regions, including the *gradual* reduction of protection while granting fiscal incentives to favour intraregional investment;

ix) Favour flexible institutional arrangements, promoting widespread participation of the countries' different social sectors.

The justification for the first five conditions is quite orthodox. The first two conditions will facilitate the achievement of economies of scale and specialization and, together with stable multilateral rules (iii) and stabilized economies (iv), would help to create favourable expectations for investment, both national and foreign. Multilateral rules and harmonized standards (iii) will also reduce administrative costs and waste. The rationale for having wide membership is

equivalent to that favouring "natural" partners (i.e., partners with a high proportion of reciprocal trade): namely, reducing the probability of having to purchase imports from more costly producers, while facilitating imports offered by least-cost producers: an outcome that will also be aided by low levels of protection against third party competitors (v). Larger markets will also promote greater investment. Common external tariffs (v) will discourage triangulation and contraband, and will avoid the need for strict rules of origin, which are increasingly being used as disguised instruments of protection.

The justification of the following conditions may be less well known or more controversial. The reduction of transaction costs (vi) may eliminate trade diversion resulting from preferences completely, since it can reduce the price of regionally produced goods and services below those of imports obtained from outside the region (Reynolds, Thoumi and Wettmann, 1993). Meeting this condition may need sizeable investments or substantial institutional reforms, requiring careful cost-benefit evaluations. Flexible sectoral agreements favouring the transfer of technology (vii) are part of a new division of labour with high information requirements, in which

there is a growing de-verticalization of larger firms, geographical decentralization and subcontracting of productive activities, with an ongoing need for innovation and the diffusion of technology. These are also part of what can be considered as an innovation-led process of integration.

Allowing for gradual adjustment processes (viii) is based on the presumption that markets do not respond immediately to changing relative prices, especially in the case of imperfect and incomplete markets, both of factors and of final goods and services, above all in underdeveloped countries. Subsidies to favour intraregional investment in the less developed countries (viii) assume that those countries which gain most can compensate those which gain less or experience losses, and that the success of integration agreements can be undermined by member countries which do not benefit significantly from the integration process. Flexible institutional arrangements (ix) presume a process of integration which is still relatively "shallow" and in a state of flux, while greater participation of the different social sectors is a proposal which is in accordance with the democratic spirit prevailing in the region.

IV

Obstacles to furthering integration

Renewed interest in integration has been partly motivated by the recent wave of democratically elected governments in the region. The Rio Group, which is a forum for dialogue and coordination that includes South American countries and Mexico, was created in this context. Integration, correctly or not, has been adopted as an instrument intended to strengthen democracy and to strengthen links between democratically elected governments. This has often led to a gap between general declarations on the merits of integration and specific integration agreements, but there is no doubt that recent economic integration efforts are widely perceived as part and parcel of a new "ethos" associated with democracy at a regional level. In what follows, some of the obstacles faced by economic integration in this new context, and the reasons for this gap, are identified.

1. The dangers of "closed bilateralism"

The proliferation of bilateral agreements may entail different costs. These range from administering a network of agreements, or the wear and tear that governments undergo in the process of repeated negotiations, to the danger of making small countries adjust to conditions existing in a large neighbouring trading partner rather than to those of the world economy (Duncan, 1950). They also include the polarization of investment that may arise from "hub and spoke" situations in which the "hub" has access to more markets and cheaper inputs² (Wonnacott, 1991). Some of

² Colombian textile producers, for example, expressed objections to the G-3 integration agreement (Colombia, Mexico and Venezuela) because of Mexico's preferential access to chemical and cotton fibres imported from the United States. They have argued that in practice it would be difficult to determine the origin of inputs in cases like this.

these costs may be reduced to the extent that bilateral agreements are between countries which are major trading partners, but there is a danger that political expedience and common economic policies may favour agreements which do not necessarily coincide with this criterion. Thus, a rather limited "closed bilateralism" instead of open regionalism could then prevail, especially if balance of payments problems resulted in the application of greater protection *vis à vis* those countries which are not part of integration agreements.

2. Differing stabilization and adjustment patterns

Macroeconomic imbalances have been an important source of friction and of obstacles which have made it difficult to attain integration agreements of wide geographical coverage. Specifically, tensions are likely to arise when countries with very different rates of inflation try to integrate, since there will be continually changing relative prices at the bilateral level. For example, bilateral exchange rate variations have been a source of tension between Brazil and Argentina within MERCOSUR. Macroeconomic risks may also arise from the uncertain prospects regarding capital flows to Latin America, which in recent years have served to cover growing trade deficits while appreciating each country's exchange rates. Economic integration accompanied by highly appreciated exchange rates could give rise to all kinds of protectionist pressures and could eventually lead to a spiral of competitive devaluations. To the extent that stabilization processes are not consolidated in the region there is always the danger that integration could exacerbate intraregional conflict rather than promoting cooperation.

Moreover, differing progress in terms of stabilization and adjustment has led to the establishment of separate categories of relatively more successful and relatively less successful groups of countries, which do not coincide with the traditional integration groupings, in which geographical proximity appeared to be the determining criterion for association. In fact, differing degrees of progress in adjustment has become a divisive issue which in recent years has led to exploration of the possibility of creating alternative integration arrangements to those existing in the past.

To begin with, the conditions attached to entering NAFTA, even though not yet explicitly stated, tend

to coincide with what is known as the "Washington Consensus" and with conditions existing in those countries, such as Chile, which have advanced most in terms of adjustment (IDB/ECLAC, 1993). This favours efforts for the individual accession of these countries to NAFTA, rather than having to wait for the remaining countries, which are members of older and more traditional Latin American integration agreements. Thus, on different occasions representatives of Costa Rica, Jamaica and Colombia have expressed the desire to accede to NAFTA individually, without having to wait for other members of the Central American Common Market, CARICOM or the Andean Pact.

Within Latin America, the countries which have advanced most in terms of controlling macroeconomic imbalances, especially inflation, have been those most prone to engage in integration agreements. This partly explains the initiatives by Chile and Mexico involving the conclusion of bilateral or trilateral agreements with other countries in Latin America, as well as the fact that Brazil is one of the countries with the least number of bilateral trade agreements in the region. Other countries like Colombia, Venezuela and Costa Rica, which belong to subregional agreements like the Andean Pact or the Central American Common Market, but which appear to have advanced most in terms of stabilization and adjustment, have also entered into negotiations to reach bilateral agreements with third countries, leading to some resentment and criticism on the part of the rest of the member countries. This has also favoured the multiplication of overlapping preferential agreements, in which older "historical" agreements, often kept alive mostly by political and geographical considerations, coexist with newer bilateral or trilateral agreements which reflect greater affinity in terms of economic policies.

Conflicting agreements may also be associated with factors that go beyond macroeconomic policy differences. For instance, an important example of conflicting arrangements involves Mexico, which as a result of its membership of NAFTA was forced to break one of the Latin American Integration Association (ALADI) rules. Article 44 of the Treaty of Montevideo whereby ALADI was set up establishes that any preference granted by a member to a third country must be extended to the other ALADI members, which would mean that Mexico would have to extend the same treatment that it extends to US

exports to its imports originating in ALADI countries. This clause led to a request for an *ex-post* waiver by the Mexican Government, which gave rise to complex negotiations within ALADI, due mostly to Brazil's concerns. Furthermore, in what is still a tentative proposal, Brazil has recommended the creation of a South American Free Trade Area, reflecting both economic and geopolitical concerns.

In general, there would appear to be a pattern which involves the abandonment of wider integration schemes (often more formal than real) for geographically more restricted but economically more meaningful integration agreements. Political costs resulting from abandoning older agreements accompany potential economic benefits resulting from the newer agreements. The different degrees of progress in terms of stabilization and adjustment tend to reinforce this pattern, making it difficult to reach integration agreements that are both deeper and wider, as MERCOSUR aims to be. Furthermore, these different rates of progress in adjusting may also be a source of a growing gap between those countries which would enter NAFTA initially and those which would not, since the latter would be most affected by diversion of trade and investment.

3. Going beyond "shallow" integration

The overall adjustment costs of Latin American integration have not, at least until recently, been a major policy issue in most of the region's countries nor, therefore, a major obstacle to furthering integration in the region. On the one hand, unilateral trade liberalization generally took place before the new integration agreements were put in place; adjustment costs were mostly associated with opening up *vis à vis* the rest of the world, rather than with trade liberalization at a regional level. On the other hand, intraregional trade liberalization has advanced gradually, mostly through bilateral trade agreements among countries which historically have not been major trade partners, while the expansion of intraregional trade has been the result, to a considerable extent, of unilateral liberalization. This would suggest that a rather "shallow" form of integration has predominated.

Furthermore, with the unilateral trade liberalization that has taken place, there is a danger that newer instruments of protection will be used to avoid some of the effects resulting from the expansion of intrare-

gional trade, especially when overvalued or appreciating exchange rates exist. Specifically, there is evidence of growing use of anti-dumping duties to block or reduce competition from greater intraregional imports, as the recent application of antidumping duties in Mexico against Chilean fishmeal illustrates (*El Financiero International Edition*, 1994).

An indicator of the difficulty in deepening integration in Latin America, and of going beyond "product integration" to "policy integration", is the absence of agreements which involve common external tariffs. A specific source of difficulty has arisen from the different degrees of earlier unilateral trade liberalization associated with the adjustment processes, with differences which are mostly of a sectoral nature. For example, in early 1994 the MERCOSUR members were not able to reach an agreement on a Common External Tariff, mostly because Brazil favoured higher protection in certain sectors (e.g. capital goods) in which it has higher average tariffs than the rest of the MERCOSUR members. Furthermore, there could be a trend towards including sectoral arrangements in other bilateral (e.g. Mexico-Chile) or trilateral (Mexico-Colombia-Venezuela) integration agreements, with special rules of origin and safeguards such as those already existing in the case of automobiles, thus effectively postponing reciprocal trade liberalization. Different domestic prices for oil and oil derivatives have also been a source of friction, since they may have effects similar to those of a subsidy.

In general, different sectoral priorities, and the desire to keep open the option of bargaining bilaterally with other parties, have meant that most integration agreements do not include the establishment of common external tariffs. The desire to keep open individual bargaining options has been an obstacle to reaching a Common External Tariff in Central America, in spite of the fact that the countries' structural adjustment agreements with the World Bank have led to a convergence of tariff levels that has created the basic conditions required to apply such a tariff.

Furthermore, as indicated earlier, most integration agreements in the region do not yet involve significant progress in terms of their coverage of services, investment and intellectual property. For instance, Chile's bilateral integration agreements have consisted mostly of agreements liberalizing trade in goods. When other themes such as investment and

certain services (mostly transport) have been considered, they have usually been dealt with in clauses of a general nature, and potential agreements on more specific issues have been left for discussion in the distant future. When, on the other hand, issues such as intellectual property and government procurement have been included, this has led to prolonged negotiations, as Mexico has discovered. This probably explains why Chile has signed more bilateral integration agreements than Mexico.

4. Equity among and within nations, and institutional requirements

Agreements that discriminate implicitly against the smaller, less developed countries, either through the use of demanding rules of origin or by restricting the liberalization of trade in agricultural products, could become an important obstacle to integration. Specifically, the application of rules of origin with higher local content requirements favours more developed countries and discriminates against manufactured exports of the smaller economies, which usually have industrial sectors which are highly import-intensive, as well as against those countries with high proportions of foreign firms which utilize imported inputs. In addition to this, giving preference to the liberalization of industrial rather than of agricultural goods further discriminates against the relatively less industrialized countries. Both themes are likely to be major negotiating issues in Latin America in the future.

Furthermore, although there is growing recognition of the fact that non-reciprocity is no longer a

very useful trade bargaining strategy, the smaller and relatively less developed countries in the region continue to request some kind of special and differentiated treatment, specifically longer adjustment periods in cases of reciprocal trade liberalization commitments. This is not an unreasonable demand, even though it also applies to all cases in which product and factor markets are imperfect or incomplete and is not restricted to the relatively less developed countries of the region.

Thus, although both the identification of Latin American integration with common cultural and historical traits, and the unilateral trade liberalization that has already taken place, tend to reduce opposition to integration agreements, the question of adjustment costs remains. These adjustment and transition issues resulting from economic integration can also be seen as part of a process leading to the reduction of transaction costs at a national level, favouring the vertical integration of markets in each country in addition to the horizontal integration of markets of different countries. This involves a challenge of an institutional nature, since reformed and liberalized product and factor markets need new forms of regulation and supervision, as well as requiring consensus to ensure effective implementation: one of the weak spots of the adjustment policies applied in Latin America (Naim, 1993). At the regional, Latin American level, this institutional challenge is less urgent, since it involves responding to conditions of integration which are only beginning to develop, although it must take into account the requirement for greater participation in keeping with the progress of democracy in the region.

V

Conclusions

A series of bilateral agreements and a new sub-regional agreement –MERCOSUR– mark the beginning of a new stage of integration in Latin America, mostly characterized by more pragmatic and less ambitious integration efforts than in the past. Actual integration is also being fuelled by non-discriminatory policies such as unilateral trade liberalization and deregulation, which have favoured the growth of reciprocal trade and investment within the region.

Open Regionalism, as proposed by ECLAC, involves the interaction of both elements, that is, of policy-led integration and of *de facto* integration encouraged by non-discriminatory policies, in such a way as to facilitate the development of the Latin American countries' competitiveness while constituting a building block for a more open international economic system. The prospects of Open Regionalism in Latin America will depend on how different

obstacles facing integration are dealt with, including problems arising from the existence of different degrees of stabilization and adjustment of those countries wishing to integrate, as well as tensions resulting from the existence of sectors which are more sensitive to trade liberalization than others, especially in the presence of underdeveloped markets or overvalued exchange rates. To the extent that stabilization and adjustment processes advance, these

problems may become less important. However, this also requires significant progress in terms of institutional reform, mostly at a national level, whereas the still relatively "shallow" and *ad hoc* process of integration currently underway would not appear to require the creation of ambitious institutions for the time being.

(Original: English)

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