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Trade Liberalization in the Western Hemisphere

INTER-AMERICAN DEVELOPMENT BANK (IDB)
ECONOMIC COMMISSION FOR LATIN AMERICA
AND THE CARIBBEAN (ECLAC)

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FOREWORD

Trade liberalization has become most relevant for the development of Latin American and Caribbean economies. Global trade policy and intraregional trade agreements raise issues that contain many common features. The 1991 Enterprise for the Americas Initiative not only called for a detailed analysis—especially from the Latin American and Caribbean perspective—but it also acted as a catalyst for revisiting the topic of preferential trade agreements.

It was natural for the Inter-American Development Bank and the Economic Commission for Latin America and the Caribbean to combine their resources to promote analysis and debate of the multiple implications of hemispheric trade liberalization. The two organizations have collaborated frequently to deal with major development issues. Each brought to this new association its unique assets to generate a set of issues papers and to provide venues where the issues could be aired and ideas discussed.

Both institutions are committed to the concept of trade liberalization, but they recognize that there is ample scope for debate regarding the content, sequence, and extent of liberalization. In selecting the consultants for the project, care was taken to offer many points of view from distinct perspectives. The purpose of the project was not to defend a particular point of view but to establish the parameters of the debate and help clarify the issues.

Several hundred officials and other leaders of Western Hemisphere nations were involved in the discussions. We are convinced that the debate is not over, but is only now beginning.

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ACRONYMS AND ABBREVIATIONS

ACP	Africa, Caribbean, and Pacific group of development countries
ACTPN	Advisory Council for Trade Policy and Negotiations (United States)
AD	Antidumping (duties)
AFTA	ASEAN Free Trade Area
ANCOM	Andean Common Market (Peru, Ecuador, Bolivia, Venezuela)
ASEAN	Association of Southeast Asian Nations (Malaysia, Singapore, Thailand, Indonesia, the Phillippines, and Brunei)
BPT	British Preferential Tariff
C/LAA	Caribbean/Latin American Action
CACM	Central American Common Market (all of Central America except Panama)
CARIBCAN	Caribbean-Canada trade preferences
CARICOM	Caribbean Community
CBERA	Caribbean Basin Economic Recovery Act
CBI	Caribbean Basin Initiative (all of Central America plus Jamaica, Haiti, Trinidad and Tobago)
CCC	Customs Cooperation Council
CEPT	Common effective preferential tariff
CET	Common external tariff
CP	Contracting Party or Parties (to the GATT)
CU	Customs uniton
CUSTA	Canada-United States Trade Agreement
CUSTC	Canada-United States Trade Commission
CVD	Countervailing duty
DS	Duspute settlement
EAI	Enterprise for the Americas Initiative
ECLAC	United Nations Economic Commission for Latin America and the Caribbean
EEC	Enropean Economic Community
EFTA	European Free Trade Area (Austria, Finland, Iceland, Leichtenstein, Norway, Sweden)
EU	European Union
FDI	Foreign Direct Investment
FTA	Free trade area, free trade agreement
GATT	General Agreement on Tariffs and Trade
GPT	Genral Preferential Tariff
GSP	Generalized System of Preferences
IDB	Inter-American Development Bank
IMF	International Monetary Fund
IPR	Intellectual property rights
ITO	International Trade Organization
LAIA	Latin American Integration Association
MERCOSUR/ MERCOSUL	South American Common Market (Argentina, Paraguay, Uruguay, Brazil)
MFA	Multi-Fiber Agreement
MFN	Most Favored Nation

MTN	Multilateral trade negotiations
MTS	Multilateral Trading System
NAFTA	North American Free Trade Agreement
NIC	Newly industrialized country
NP&EE	New plant and equipment expenditures
NR	Natural resource
NTB	Nontariff barrier
OAS	Organization of American States
OIP	Other industrial products
PNR	Processed natural resources
RO	Rule(s) of origin
S & D	Special and differential (treatment)
SELA	Latin American Economic System
SITC	Standard Industrial Trade Classification
STC	Standard Trade Classification
TRIM	Trade-related investment measures
TRIP	Trade-related intellectual property
TRQ	Tariff-rate quota
UNCTAD	United Nations Confrence on Trade and Development
USTR	United States Trade Representative
VER	Voluntary export restraint
WTO	World Trade Organization

INTRODUCTION

ECLAC

This volume is the product of a joint project of the Inter-American Development Bank (IDB) and the United Nations Economic Commission for Latin America and the Caribbean (ECLAC) in "Support of the Process of Trade Liberalization in the Western Hemisphere."

When the IDB-ECLAC project was launched in 1991, the Enterprise for the Americas Initiative (EAI) of the Bush Administration was one year old. The initiative envisioned a process of trade liberalization that would lead to a free trade area in the Western Hemisphere, built around the principle of reciprocal, rather than unilateral, trade concessions. The EAI proposed what amounted to a new form of integration between developed and developing countries through a partnership built around equivalent concessions.

The proposal aroused great enthusiasm, but it also raised many questions about its content, scope, and implementation. The IDB-ECLAC project was designed to promote a dialog on the process of trade liberalization in the Western Hemisphere, with the hope of shedding light on the options opened by such a process.

The project produced seventy papers, most by trade experts. The papers were discussed in seven colloquia and two conferences between January 1992 and December 1993 at the University of Toronto, Canada, the Federation of Industries of the State of Sao Paulo, Brazil, and at the IDB and ECLAC headquarters in Washington, D.C., and Santiago, Chile. More than 400 participants from the public and private sectors, research and academic institutions, international organizations, and nongovernmental organizations from throughout the Americas, Europe, and Japan came together to exchange views on the prospects for trade liberalization in the Western Hemisphere.

Over the course of the project, the participants addressed numerous conceptual, methodological, and practical topics related to hemispheric trade liberalization. Of great interest was its compatibility with the ongoing Uruguay Round negotiations and how liberalization would affect the global trading system; or the conditions for its success, particularly the methods and sequencing of alternative negotiations; the negotiating agenda and sequence for the participation of individual countries or groups of countries.

Most discussions, however, centered on three basic issues: What might a country hope to achieve from participating in the process of hemispheric trade liberalization? What conditions are essential in order to maximize potential gains? And, How best to go about liberalizing trade in the Hemisphere?

Potential Gains

In theory, unilateral trade liberalization can make it possible for a country to attain the maximum income. However, without universal liberalization, unilateralism is not as powerful, even though it is beneficial in aggregate terms. In a world of trade restrictions, a free trade agreement can open markets, a gain that is not necessarily available via unilateral trade liberalization. When trading groups are strengthening themselves and nontariff restrictions are rising, reciprocal opening, or the commitment to keep markets open, can be an advantage of a circumscribed free trade agreement.

A commitment to establish a free trade area can also bolster the credibility of sustaining economic policies and solidifying past reforms. This is the so-called locking-in effect, and it offers more than the conventional efficiency gains associated with unilateral liberalization. It is also plausible that these gains may not be substantial. This is particularly true for some Latin American and Caribbean countries that have already undertaken unilateral trade liberalization as part of a deliberate—and often painful—strategy of relying on the market, privatizing state enterprises, and improving macroeconomic performance.

Inclusion in a continental free trade agreement is a far better option than exclusion. The costs of exclusion are likely to encompass the diversion of trade and investments as well as lost opportunities for growth through economic cooperation in a broad range of issues. This is more obvious for smaller economies that have relatively lower potential to benefit from economies of scale. At a time when regionalism is growing and free trade faces new challenges, it makes sense to undertake simultaneously the creation of a free-trade area and unilateral trade liberalization.

What Kind of Trade Liberalization?

The formation of trading blocs can help or hinder global trade liberalization. Some fear that a free trade agreement could create a form of prisoners' dilemma, whereby rational actions at the regional level produce a negative global outcome. Preferential schemes, it is argued, violate the spirit of multilateralism, breed defensiveness, and can become insular trading blocs.

A move toward liberalization is said to be GATT-compatible if it does not violate provisions of the GATT, especially Article XXIV, and GATT-plus if it moves further toward liberalization than required by the GATT.

There is, however, a growing consensus that the multilateral system does not represent a unique track toward freer trade. Circumscribed, as opposed to global, trade liberalization can be trade-creating, GATT-compatible or, better still, GATT-plus. Regional trade liberalization should not be a threat to multilateralism. Rather, regional agreements may break down barriers on a limited regional scale, and this can create precedents and generate competitive forces that help propel broader liberalization efforts.

ECLAC advocates an "open regionalism" that results from the interdependence of special, preferential agreements and market signals produced by trade liberalization. What open regionalism seeks to accomplish is to make explicit integration policies compatible with, and complementary to, multilateralism.[1]

Whether regional arrangements in general are positive or negative for the global trading system will likely remain a matter of dispute. Widespread certainty exists, however, that complete free trade in the world is the best outcome and, consequently, trade agreements that complement multilateralism are better than those that do not. The question that must be answered is, What kinds of circumscribed trade agreements are GATT-plus and therefore more likely to generate increased gains?

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1. ECLAC, 1994, *Open Regionalism in Latin America and the Caribbean: Economic Integration As a Contribution to Changing Production Patterns with Social Equity.* [LC/L.808(CEG.19/3)] Santiago, Chile.

First, *it is essential that the regional trade agreement be based on a partnership and built on the principle of reciprocal concessions.* As such, it will demand commitments and obligations over a broad range of issues. For instance, if the recently approved North American Free Trade Agreement (NAFTA) is taken as a guide, countries interested in undertaking regional trade negotiations should be prepared to address both traditional obstacles such as tariffs and quotas and new issues such as investment, intellectual property rights, government procurement, and rules to deal with unfair trade practices. The environment and labor, as well as governability or the rule of law, can also be part of the expanded agenda.

An innovative regional agreement has the potential of providing precedents in areas not yet covered by global trading rules. More important, the inclusion of issues that are part of the political agenda of modern open economies can be viewed as an opportunity to continue along the path of economic modernization. To the extent that changes in domestic policies are beneficial, modernizing countries will be able to sustain their commitments in these areas by forming strategic alliances with analogous groups from their trading partners.

Other essential characteristics of a GATT-plus trade agreement are *equal treatment to new members, clear terms of accession, and precise rules.* A regional trading agreement that does not offer new membership on terms equal to those of existing members can generate instability in foreign investment flows and perhaps cause trade and investment diversion.

When countries of different sizes and degrees of development are called to operate on reciprocal, rather than unilateral, terms and concessions, the principle of equality among members and of open access to new members means that there is equality of opportunity for all countries to reap the potential benefits of economic integration. Smaller or relatively less-developed newcomers may require lengthier phase-in terms instead of the special, nonreciprocal treatment they once demanded. Present circumstances indicate that demands for such special, nonreciprocal treatment may hinder the possibilities of concluding regional integration agreements.

Members that are less able to take advantage of the broadened market could explore the possibility of moving gradually, but progressively, in their commitment to the process of reduction of obstacles and easing, to some extent, the costs of adjustment. Lengthier terms and conditions may facilitate the emergence of genuine partnerships between members of different sizes and levels of development.

It is essential that terms of accession be clearly spelled out for the benefit of potential members. Stable and transparent terms of accession will help those interested in engaging negotiations. Beyond accession, *it is also desirable that a regional free trade agreement be governed by rules that are transparent, precise, and clearly spelled out.* This is especially important in areas such as dispute settlement mechanisms, safeguards, and rules of origin. For example, different types of dispute settlement procedures and their implementation in various regional trading arrangements should be observed carefully. Experience reveals that a carefully constructed and effective dispute settlement mechanism can help equalize differences in relative economic weight. This is true even for agreements that do not attain the most advanced supranational legal regimes that govern trade and other economic relations among the member countries of the European Union (EU).

A free trade agreement aimed at reducing friction among its members should have an effective dispute settlement procedure at its core. Disputes could arise from use of unilateral remedies, which are often part of national legislation and therefore are not affected directly by an international agreement.

Clear rules on safeguards are also necessary. Safeguards provide both the means to minimize adjustment costs and political flexibility for decision makers. Without an agreement on safeguards, negotiators of a free trade agreement will be limited in what they can accomplish.

Finally, poorly negotiated and obscure rules of origin can limit the gains to members of a free trade agreement, especially for smaller countries. It is essential to avoid rules of origin that are restrictive and rigid. One of the best ways to overcome some of the problems generated by overly restrictive rules of origin is to reduce their importance by reducing barriers to trade from sources outside the free trade area.

How to Proceed

Over the course of the Project the questions of how to move toward a future hemispheric free trade area and what to do at the present received much attention. The current stage of transition, although still somewhat ambiguous, offers countries the opportunity to prepare for mutually beneficial negotiations in the future.

Central to the discussion about how to proceed is whether "widening" or "deepening" existing subregional integration schemes should come first. Whatever path is taken, hemispheric negotiations will test the cohesion of the subregional integration schemes. Tensions and strains are already present, since the mere possibility of undertaking negotiations has exacerbated some of the differences, particularly because of uneven speeds of unilateral trade liberalization.

Some believe that priority should be given to strengthening subregional arrangements to make them the building blocks of hemispheric free trade. However, even if the deepening of subregional integration arrangements becomes a primary vehicle for hemispheric trade liberalization, laggards could slow the process. An alternative, more viable strategy could be simultaneously to deepen subregional groupings and proceed to liberalize trade in the hemisphere. The two processes could become mutually supportive.

Furthermore, different countries or subregions find themselves at different levels of readiness to move forward. This readiness level, based on the consolidation of macroeconomic stability and the market orientation of policies, could influence a country's ability to reap the benefits of hemispheric trade liberalization.

There appears to be a degree of consensus in Chile, for example, that the country is ready to reap a net welfare gain by increasing and diversifying its exports. No similar consensus yet exists, however, in the case of Brazil. Doubt remains as to whether hemispheric trade liberalization would best serve the country's interests.

Even if Brazil were, after Mexico, the country that stands to benefit the most from liberalization, skeptics point out that it would face significant trade diversion, given Brazil's high level of import and export diversification. The potential for retaliation by the European Community, Brazil's largest trading partner, as well as an unstable macroeconomic situation, have been obstacles to closer hemispheric trade relations.

In contrast, others argue that the major advantage for Brazil (and for the rest of Latin America) of joining a hemispheric free trade agreement is to end the marginalization and isolation they have experienced. The major danger is described as being excluded from emerging blocs, and hemispheric liberalization is perceived as offering the best, if not the only, opportunity available to eliminate that danger.

Some tasks could be carried out during the present stage of transition despite individual variations in level of readiness: for example, consolidation of domestic reforms and adding to mutual knowledge.

Trade liberalization by itself would not become the "driver" of the development process and, while it is a necessary condition, it is not sufficient. However, if free trade is combined with other appropriate domestic policy measures, synergism is possible and the benefits can be significant. Consolidation of domestic economic reforms is seen as the principal task; a country's own policies are at least as important as a trade agreement for the improvement of its efficiency and insertion into the international economy.[2]

A second major task consists of increasing the mutual knowledge that is required by beneficial negotiations. Countries require access to information germane to commercial integration to proceed with any kind of hemispheric liberalization. Mutual knowledge implies increased awareness of the negotiating processes, some of which are fully open and subject to intense debate and pressures from a wide array of interests.

Besides increased mutual awareness and identification of possible sources of opposition, it is necessary for negotiators to understand fully the sources of the skepticism that still exist about hemispheric trade liberalization. Some of these arguments were on full display during the debate that took place before the approval of NAFTA. From these debates it was clear that hemispheric trade liberalization is far from being a free lunch, and it is far from being a panacea.

Finally, hemispheric trade liberalization demands caution. It is a journey into unknown territory, and costs and benefits cannot be accurately assessed in advance. However, it demands serious attention as well since it clearly supports the broad objectives of development.

2. ECLAC, 1994. *Latin America and the Caribbean: Policies to Improve Linkages with the Global Economy.* [LC/G. 1800 (SES.25/3)] Santiago, Chile.

Overview of the Book

This volume contains some of the papers commissioned by the IDB-ECLAC Project. The papers are grouped into four sections, and they offer a wide range of perspectives on conceptual as well as practical aspects of hemispheric trade liberalization.

Part one includes three papers that focus on the overall impact of hemispheric trade liberalization. Max Corden's paper provides a theoretical framework for analyzing the potential effects of a free trade area from the perspective of Latin American countries. Of these effects—liberalization, trade diversion, and reciprocity—Corden believes reciprocal opening, or commitment to continued market access will be the most important. This opening also includes changes in domestic policies such as subsidies, labor, and environmental regulation.

Rudiger Dornbusch sets out the case for regionalism as a way to open markets and pursue freer trade. He argues that regional developments are not a threat to multilateralism, but provide a way to break down barriers on a limited regional scale and create precedents, blueprints, and competitive forces that will help drive a broader liberalization effort.

Robert Pastor views NAFTA, too, as a catalyst for expanding trade and improving the rules and institutions of the world trading system. It has the potential to make the Americas the center of the global economy and the model for North-South relations in the twenty-first century. NAFTA does not represent an exclusive trading bloc, holds Pastor. It is rather the deepening of the last major trading area in the world; North America and eventually the Western Hemisphere.

In the second section, the papers by Anne Krueger, Hans Singer, Robert Blecker, William Spriggs, and Graciela Chichilnisky focus on *what kind* of free trade agreements are desirable. In this sense, Krueger's paper offers a framework for assessing alternative free trade agreements. She also highlights the kinds of policies that Latin American countries could adopt to provide the maximum scope for gains under a Western Hemisphere free trade agreement.

One desirable characteristic of a free trade area, according to Chichilnisky, is that trade should be structured around economies of scale rather than around traditional comparative advantages. If trade is based on economies of scale, it is more likely that the free trade agreement will complement rather than substitute for global trade negotiations.

Singer's paper focuses on the likelihood of a beneficial free trade agreement among countries of different levels of economic development. For a "genuine partnership" to emerge, he proposes conditions to enable countries to take advantage of the opportunities opening to them and to ease the costs of adjustment. Blecker and Spriggs also focus on the need for strengthening policies such as adjustment assistance and labor retraining to ease the adjustment costs and to work toward the eventual international harmonization of labor standards and enforcement.

Part three consists of seven papers that address key negotiating issues. David Palmeter discusses the need to avoid restrictive and rigid rules of origin. The less important are rules of origin in an agreement, he points out, the better the chances of avoiding problems. This conclusion is also shared by Isidoro Hodara, whose paper analyzes the potential effects of liberalization of trade in clothing and textiles.

James Cassing's paper points out that a good safeguards agreement is also crucial. A clear agreement on safeguards enhances the negotiating capacity of countries and as a consequence also increases the gain to countries joining a free trade area.

Several authors stress the importance of negotiating a precise dispute settlement mechanism. Blair Hankey reviews different types of dispute settlement mechanisms and their implementation in various regional trading arrangements. He concludes that it is the most promising institution to deal with countries of different bargaining power.

In his analysis of Section 301, Steven Husted also favors a strong dispute settlement mechanism to reduce possible frictions from closer commercial links and the likelihood of U.S. firms seeking unilateral remedies. Also, Gilbert Winham and Heather Grant stress that an effective and binding dispute settlement mechanism serves to restrain the use of antidumping and countervailing laws.

Charles Pearson addresses the new issue in the agenda; how to harmonize trade and environmental policies within the context of regional economic integration arrangements. He notes that conflicts can be easily exaggerated, but there are points at which trade and environmental regimes need to be reconciled.

Finally, part four contains papers that deal with how to proceed toward a hemispheric free trade agreement and individual country perspectives. Sidney Weintraub takes on the issue of "widening" or "deepening" of subregional integration schemes. He proposes that priority be given to strengthening subregional arrangements so that they can become the building blocks of hemispheric free trade.

The next five papers deal with individual country perspectives. Andrea Butelmann and Patricio Meller analyze the case of Chile, a country where it is widely believed that moving towards the formation of a free trade area would bring about welfare gains. The authors estimate that such a move would cause a net increase of Chilean exports of approximately 4.4 percent.

The papers by Marcelo de Paiva Abreu and Luiz Bresser Pereira and Vera Thorstensen, illustrate different assessments of Brazil's trading options. While Paiva Abreu emphasizes the potential trade diversion and retaliation Brazil could face if it pursued integration with the United States, Bresser Pereira and Thorstensen highlight the danger of being excluded from a hemispheric trade agreement.

In turn, the paper by Winston Dookeran presents key policy issues faced by small economies such as those of Caribbean countries, and, in particular, how they respond to the fast-changing international trading regime. Last, Jeffrey Hayes and Seymour Lipset focus on the United States. Their contribution, a historical overview of the social roots of protectionism, presents a complex portrait of U.S. protectionism.

I. The Overall Impact of Hemispheric Trade Liberalization

A WESTERN HEMISPHERE FREE TRADE AREA: IMPLICATIONS FOR LATIN AMERICA

W. Max Corden

The Enterprise for the Americas Initiative (EAI) launched in 1990 included a proposal to establish a Western Hemisphere free trade area. The idea was to start with bilateral free-trade negotiations, those between the United States and Mexico being the pilot case, using the Canada-U.S. free trade agreement as a model. The EAI was concerned not only with trade policy but also explicitly with investment, debt, and the environment. Although experience in Europe suggests that many considerations other than purely economic ones motivate progress toward regional free trade, this paper will be limited to considering trade policy and, apart from reference to the political economy of trade liberalization, will leave aside broader political issues.

The aim of this paper is to provide a framework for analyzing the potential gains and losses of forming a free trade area (FTA) from the point of view of individual Latin American and Caribbean countries. The paper is basically theoretical and draws attention to the numerous and complex issues involved. Latin America and the Caribbean, or LAC, will be used 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.

The main analysis, Part I of the paper, distinguishes between and analyzes in detail the effects of (a) liberalization, (b) trade diversion, and (c) reciprocity. Clarifying the distinctions among these three effects of an FTA will be helpful in sorting out the issues. The analysis in Part I makes 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 country. The special interest of the United States, or any interest group within it, will be briefly discussed in Part II. Thus, this paper is primarily a guide for analysts and policy makers in LAC. The interest of the world community as a whole will not be considered.

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

Third, it will be assumed that macroeconomic adjustments—including exchange rate adjustment and appropriate fiscal and monetary policies—will 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. The implication of an FTA for exchange rate policy will be discussed in Part II.

I. The Three Effects: Liberalization, Trade Diversion, Reciprocity

Liberalization by LAC Countries

The first of the components of an FTA is *trade liberalization* by the FTA itself. Tariffs are reduced or 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 the exchange rate depreciation likely to be associated with liberalization. Such gains may also accrue to import-competing producers. Inevitably there will be gainers and losers, and unemployment may increase in the transition. There are also benefits attributable to the reductions in 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 between different industries and their workers may eventually be substantial.

Trade liberalization can take three forms: unilateral, multilateral, and regional. It is worth comparing the effects of the three. Table 1 shows that they have some similar effects.

First of all, liberalization can be unilateral and nondiscriminatory, a policy 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, liberalization does not need to be associated with any international agreement, and it does not explicitly discriminate between different foreign suppliers. Unilateral liberalization was pursued by Chile in the 1970s, more recently by Mexico and Argentina and, to a lesser extent, several other LAC countries.

Second, liberalization can be multilateral. In the postwar years multilateral liberalization in manufactured trade took place among developed countries under the GATT. Essentially it means that a country's own liberalization is supplemented by liberalization by others and opens export markets for the country and improves its terms of trade relative to the unilateral alternative. This is *the reciprocity effect,* to be discussed below. Clearly, a country benefits when its own liberalization is associated with reciprocal liberalization by its trading partners.

Finally, there is regional liberalization, of which a bilateral FTA is a special case. A country's own liberalization does not necessarily apply to imports from all countries, only to those from the region. In the case of a bilateral FTA between one LAC country and the United States, the LAC country may open its market only to U.S. goods. There will be the same general effects of liberalization: imports will increase, and there will be gainers and losers. But in this case liberalization is partial, and thus discriminatory. The discrimination may create *trade diversion* effects, which will 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.

Table 1
Effects of Three Kinds of Liberalization

Effects	Unilateral	Multilateral	Regional
Liberalization by LAC	√	√	√
Trade Diversion (Adverse)			√
Reciprocity (Favorable)		√	√

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

For the first group of 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 United States would have an impact only through the reciprocity effect. 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 country's own liberalization.

First, a bilateral FTA would lock in institutionally a part of the liberalization. The present degree of liberalization could otherwise be reversed by a future government. But an agreement to establish an FTA would not be easily reversible, if at all. This was 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 countries of LAC, but would certainly still be important. This "locking-in" effect has a dimension of political economy: a liberalizing government can ensure that future administrations will not be able easily to revert to protectionism.

The immediate benefit of locking in liberalization is that it is likely to stimulate 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 and not be changed unpredictably is likely to encourage both foreign and domestic investment, possibly financed by the return of flight capital as can 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 obtain imported components and inputs without restrictions or tariffs.

Second, it is likely that an FTA would involve a greater degree of liberalization and opening 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. 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 one LAC country and the United States, but it could be significant.

The other group of countries—where protection is still quite high and it is unlikely that unilateral liberalization would approach free trade—either the political will to liberalize substantially does not exist, or the political ability to bring it about is lacking. The most important country of this kind is Brazil: liberalization, both actual and prospective, on the basis of commitments, has been substantial, but Brazil is still far from achieving free trade. The formation of an FTA would raise very substantive issues for the LAC country, 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 interests resist liberalization and make it politically impossible, or at least highly painful? Should losers be provided with compensation, or can increased growth from liberalization be relied upon eventually to compensate the initial losers?

It is impossible to discuss these complex issues fully 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 have been associated with, higher growth rates. Nevertheless, it can be assumed that in LAC countries, as in all others 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 were general agreement that the broad, long-term national interest would be best served by extensive trade liberalization (possibly to the point of completely free trade), this will still run counter to the interests of particular groups. When governments are not strong, interest groups have blocking capacity.

Trade Diversion

Trade diversion is the principal negative aspect of an FTA. It results from the FTA's discriminatory effect. 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 and toward the U.S. The pattern of imports will change, and total imports are likely to increase because of the trade-creation effect. But the trade-diversion effect is adverse. Mexico will be buying goods from the U.S. that could have been obtained more cheaply from Japan.

Vinerian Trade Diversion

Suppose the LAC country has a tariff of 30 percent on all imports of a particular product. It then joins the FTA, and imports from the United States carry no tariff. However, imports from Japan must still pay a 30 percent tariff. The result is that there will be a diversion of the source of imports from Japan to the U.S. Excluding the tariff, the diverted imports will have cost less when bought from Japan than when bought from the U.S., so the LAC country is then buying a product from a higher-cost source and thus incurring an extra cost. This trade diversion concept, introduced by Jacob Viner, 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 country has followed a path of unilateral trade liberalization before joining the FTA, and hence the lower the external tariff, the lower the cost of such trade diversion will be. Nevertheless, some degree of trade diversion is likely even when a country has liberalized completely because of the locking-in and completion effects. 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 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 LAC country's 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 quotas have largely 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, "trade contraction."

Trade Contraction: Increase of Protection Against Imports

Trade contraction exists 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 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 country does not have to adopt the United States 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 increase. First, it may be brought about as a result of pressure from the United States if its 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 U.S. imports. When a particular protected industry loses sales because of increased imports from the U.S. produced by 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, which, once the FTA has been established, can be brought about only by increasing protection against imports from outside the FTA. In the past, this has taken the form of tightening or expanding the scope of quantitative import restrictions rather than raising tariffs. Other nontariff devices such as antidumping measures, countervailing duties, and voluntary export restraints accepted by exporters under threat of other measures can produce the same result.

Trade Deflection: Free Trade Area versus Customs Union

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 tariff from the LAC country. There will then be some tendency for goods to be imported from Japan into the U.S. via the LAC country: this is trade deflection. It leads to unnecessary transport costs and, more important, it defeats the purpose of the U.S. protectionist measures. The lower the transport costs, and the bigger the gap between the low tariff of the LAC country and the high tariff of the U.S. (or the tariff equivalent of the nontariff device), the greater the effect will be.

The problem is well known in an indirect form and has presented problems in the Canada-United States Free Trade Agreement. 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 U.S. may wish to restrict imports from a LAC country 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 the portion of the value of imports from (say) the LAC country to the United States that represents the part that is assumed to be of outside (e.g., Japanese) origin. The U.S. 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 will be that countries with 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, such trade deflection would be desirable, but, naturally, it is not acceptable to the more protectionist country. Another possibility—one which cannot be ruled out but would certainly be less desirable—is that the United States might pressure its LAC partner to increase its restrictions on imports from Japan to the U.S. level to reduce the incentive for trade deflection. It must also be added that this analysis is, at least in theory, symmetrical: U.S. protection may be low and the LAC country's protection high. In that case, trade deflection would consist of imports from outside entering the LAC country indirectly via the U.S., and the LAC country may then wish to apply strict rules of origin.

One 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 antidumping duties. In a customs union there would have to be an agreement about common nontariff barriers, notably voluntary export restraints. But it is hardly conceivable that this could be brought about between any LAC country and the United States, and it is not under consideration.

In practice a customs union would mean that the external trade barriers of the LAC country would be determined in Washington, D.C., since it is inconceivable that the United States Congress would allow relatively small economic partners—all countries in the Western Hemisphere are small relative to the U.S.—to play a significant part in determining its barriers against imports from, say, Japan. It is also possible that the United States will pass through its current protectionist phase and wish to liberalize imports from outside, possibly on the basis of multilateral or bilateral negotiations. But it is improbable that it would allow small LAC partners to play a part in, or even veto, its negotiations.

Reciprocity

The most important gain that a LAC country is likely to realize from an FTA is the reciprocal opening—or commitment to continued opening—of the United States market to the LAC country'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, trade creation results from the LAC country's own liberalization (which could be even greater under unilateral liberalization), and second, trade creation results from U.S. 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 offsetting terms-of-trade effects to be considered.

Extent of Gain from Reciprocity

The extent of the gain to the LAC country depends not just on the level of existing barriers to its exports in the United States but also on what these barriers might have been in the future if no FTA were established. There is a possibility that the U.S. will become more protectionist. LAC countries could well suffer from a spillover effect and from the general rise in U.S. protection. The attraction of an FTA would then be to lock in the present relatively open trade policies of the U.S. with respect to the LAC country: 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 country exports are substitutable with competing products in the United States. 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 country where the possibility of an FTA arises, a separate detailed analysis is required. Measurement of existing barriers is usually difficult because the main barriers are nontariff ones, notably the threat of antidumping 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 U.S. will not be provided. The U.S. market may not be so "safe" a haven. In the cases of the U.S.-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 countries to negotiate an agreement that will minimize the special cases and loopholes. But, of course, the LAC countries would also have to give up some of their own loopholes.

The value of an FTA to the LAC country depends on how the "safeguard problem" is handled. It is inevitable that some producers in the United States 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 are extremely common and have been allowed under GATT and also the U.S.-Canada agreement. But they represent the re-entry of protection by the back door. Measures are not usually temporary and, above all, they introduce uncertainty.

A LAC exporter who has, often with difficulty, penetrated a market in the United States must always cope with not only the normal threat of new competitors (which must be faced by all market participants) but also the threat of government intervention caused by successful lobbying. Of course, the same problem would arise for U.S. exporters in the LAC market if the same "protection-by-the-back-door" policies were followed there. A genuine FTA would avoid such safeguard interventions for the same reason that such interventions are not usually available within a single country. The hope is that, after a lengthy transition period, 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 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 to make all safeguard provisions temporary, with built-in sunset clauses to ensure automatic ending of a protectionist measure within a limited time.

Trade Diversion and the "Bandwagon"

One component of the reciprocity effect for the LAC country is trade diversion by the United States, to the benefit of the LAC country, although it harms both the U.S. and the other country or countries whose trade is diverted in favor of the LAC country. It is to be distinguished from trade diversion by the LAC country itself, discussed earlier, the effects of which are clearly adverse to it. The effect of U.S. trade diversion will be greater the higher the substitutability of the LAC country'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 U.S. of its barriers on imports from LAC country while maintaining some barriers, actual or potential, against imports from others. Of course, if the U.S. forms an FTA with more than one LAC country, 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 LAC countries.

This potential trade diversion effect provides a particular incentive for individual LACs to join the FTA "bandwagon." When LAC country no. 1 forms an FTA with the United States, there could be an adverse effect on LAC country no. 2 because of U.S. trade diversion, so country no. 2 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. There is, of course, 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 U.S. market while imposing tight protection on all other imports that compete with Mexican goods, and while Mexico itself has free trade with everyone. The problem, of course, is that this course of action is not in the interests of the U.S.

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. Strong arguments based in political economy also favor an FTA.

First, countervailing export interest groups will emerge that expect to benefit from the reciprocity aspect of the FTA—e.g., the opening of the United States market. Such interest groups have also emerged in the case of unilateral liberalization when this was associated with devaluation; in Chile and Mexico, also, exports have increased. Thus this consideration is only a matter of degree. But benefits to potential exporters from unilateral liberalization of imports associated with devaluation are more indirect and sometimes hard to imagine in advance, compared to the benefits from direct opening of a foreign market. Second, the sentiment in favor of liberalization will certainly be strengthened by reciprocal liberalization in the U.S. 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. Other Considerations

Exchange Rate Policy

How Would an FTA Affect the Real Exchange Rate?

Unilateral liberalization on a large scale inevitably requires a real depreciation to precede it or to be associated with it. There is a close connection between trade policy and exchange-rate policy, as may be found in many episodes of liberalization.

Liberalization of imports, on its own, is likely to increase the volume of imports and 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 and hence to some extent offsets 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 to ensure that the boost to exports happens in good time, and that extra jobs are available in export industries to compensate for those 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 approach in Latin America is to use some kind of "crawling peg" or frequently adjustable exchange rate with frequent nominal depreciations, possibly on a regular basis, 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 country requires associated real depreciation, this is not necessarily so when an FTA is formed. The reason is that the reciprocity effect—that is, the boost to exports resulting from the opening of the United States 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 country 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—indeed merely the expectation that one will be formed—could boost capital flow into the LAC country, 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 (that is, 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 country's own trade liberalization combined with U.S. liberalization as part of the FTA. On balance, either real depreciation or appreciation are possible.

A real appreciation could come about through nominal appreciation caused by the additional supplies of foreign exchange increasing the value of the domestic currency in the market 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.

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 country fix its currency to the dollar in order to form an FTA with the United States? 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 U.S. and Canada has been effectively free from restrictions, and yet the Canadian dollar has floated relative to the U.S. dollar. It follows therefore that a further step, namely, monetary integration—which requires a single central bank—is not necessary to have trade integration.

This simple answer covers what is possible and necessary. The answer to the question of 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 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 country might establish a currency board system where domestic currency can be created only when backed by dollars, as 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 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.

Dangers of a Fixed Exchange Rate

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 1970s and early 1980s; it is clearly preferable for exchange rate adjustments to be frequent and small rather than infrequent, large, and crisis driven.

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 to real appreciation and eventually to a foreign exchange crisis.

Third, experience shows that countries that 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 1980s)—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"—that is, policies that switch domestic demand from imports to domestic 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, and are therefore 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 United States. Not only would the LAC country's own producers be protected, but U.S. producers that export to the LAC country would also be protected. Trade diversion by the LAC country would increase, and the costs of the FTA would rise.

Fair Trade vs. 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 work force may regard the greater expenditures on education in the United States as giving its U.S. competitors an "unfair" advantage. In other fields, the high level of military expenditures in the U.S. may have given some defense industries an advantage. It is not hard to think of advantages that U.S. industries have relative to those of a LAC country, some of which may be attributable to particular U.S. government policies. But in general the U.S. 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 U.S. 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 United States may complain about "unfair" competition from the LAC country. U.S. 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 a LAC country is to form an FTA with the U.S., it may be required to change certain domestic policies to avoid complaints of "unfair" competition. This could be an important implication of an FTA. The pressure from U.S. interests is both inevitable and fully understandable. The question is whether altering its various domestic policies would be in the interests of the LAC country. If not, we have here a cost of an FTA, to be added to the trade diversion cost. For example, the LAC country may have regulations protecting workers and their conditions that are much less strict than those prevalent in the U.S. If the same regulations were introduced as exist in the U.S., labor costs would rise for firms, and the effect would be much the same as if real wages had been increased. The LAC country 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 analyze 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 covering, for example, transport, working conditions, or the environment. There are various special taxes, some of which may benefit foreign competitors of the country's 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 "nonoptimal" 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 country 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 nonoptimal, why has it not been removed? Presumably, one must simply look at each intervention under discussion. 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 country has chosen, one would regard the pressures applied by the United States negotiators in the interest of "fairness" as perceived by the U.S. 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.

Gains from an FTA for the United States

The United States is a very large area of free trade (actually, a customs union) already, and it is unlikely that the gains relative to GNP of forming an FTA with any LAC country, or even all LAC countries, 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 U.S. 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 U.S. companies that perceive profitable investment opportunities as a result of the FTA would also gain.

Suppose the LAC country 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 U.S. market, and yet it would not lose from any trade diversion away from (say) Japanese exports towards U.S. exporters. But would there be any gain for the U.S.? Leaving aside nontrade considerations, one might ask why the U.S. should commit itself to an FTA if the LAC were going to liberalize unilaterally in any case?

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

In principle, the analysis of the economic gains and losses to the United States of joining an FTA is the same as that applicable to the LAC country. The U.S. 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 U.S. industries are under competitive pressure, either from the LAC country 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 antidumping duties. If protection on imports from the LAC country 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 U.S. relative to the alternative of increasing protection in a less discriminatory way.

An FTA for LAC Countries

The whole of the preceding analysis is relevant for studying the implications of the formation of an FTA between any group of LAC countries. 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.

Likelihood of Net Gain

If, in the absence of an FTA, trade with the outside world were the major part of an LAC country's trade, then the trade creation gains are unlikely to be large and—if high levels of protection relative to the outside world remain—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 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 to unilateral liberalization. Some net gain might remain even if unilateral liberalization were not complete. But, in view of the relative importance for all LAC countries of trade with countries outside Latin America, unilateral liberalization is the more important step.

Should the FTA be Turned into a Customs Union?

The question also arises whether an FTA between two or more LAC countries might become 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 United States were not immediately 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 U.S. is to be complete, there is nothing to bargain about with regard to tariffs and other restrictions relative to the U.S., 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 (the United States, the 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 share 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 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 case by case. 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.

Multilateral Trade Negotiations and the Western Hemisphere Free Trade Proposal

One may regard multilateral free trade—or at least substantial worldwide liberalization supported by strong rules—as preferable to regional arrangements. This writer holds that view and will discuss it further, 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 a LAC country but also to consider how an FTA would affect the achievement of improved multilateralism.

How Regionalism Might Affect Multilateralism

In summary, regionalism can be seen as a supplement to multilateralism, as an alternative, or as a path toward it. The official United States 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 U.S. 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 that 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 they are creating, they see less need for making politically painful concessions in agriculture in order to achieve a Uruguay Round success. In the United States, also, there are now advocates of regionalism in preference to multilateralism based not necessarily on a view that the former is preferable, but that, because of European and possibly Japanese attitudes, the latter is a lost cause.

Finally, one can see regionalism as a path to multilateralism. This view is mentioned here only briefly since it is not very plausible. With a great act of imagination one might conceive of a small number of regional groupings—FTAs—being formed (e.g., a European, a Western Hemisphere, and an Asian FTA), and then the three would in one grand bargain open up to each other and create worldwide free trade, or something close to it. But alas, this is surely a fantasy.

A more reasonable proposal is the "open club" idea. A free trade area, with the United States at its core, could be established between a limited number of countries—for example, the North American Free Trade Agreement, 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) to provide the basis for negotiations with a new candidate. 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 until it eventually embraced the whole world. Actually, the European Community has done something like this, though the invitations have been rather limited and the applications not always accepted. It is also hard to believe that this process could 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.

Multilateralism and Regionalism Compared

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

The first and principal point is this: the FTA would open, or lock in the opening of, the United States market for the LAC country's exports. By contrast, multilateral liberalization would open and 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 could be said to favor 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 country relative to its trading partners, and the strength of the rules set up, are then relevant. Here a LAC country may be in a weaker situation in an FTA, where the United States would be clearly dominant, than in a multilateral environment where none of the three big economic powers (the U.S., the European Community, and Japan) have the same relative strength and where more will have to depend on the enforcement of universal rules. Hence, from this point of view multilateral arrangements are also preferable.

Third, the FTA gives the LAC country the benefit of some trade diversion in its favor in the United States market—as LAC exports replace exports from Asia, for example. This effect is not in the U.S. or the general world interest, but it is a benefit to the LAC country itself, and thus is an argument favoring the FTA relative to multilateralism. This benefit depends, of course, on the U.S. continuing to impose tariffs, quotas, or voluntary export restraints on imports from outside.

Finally, we may consider a LAC country 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 of these would be politically more persuasive. If the Uruguay Round is successful, LAC countries 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 promoting domestic liberalization.

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 LAC countries, but most LAC countries 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.

Countries that are small in the world economy—like all countries in the Western Hemisphere other than 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 U.S. 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 group 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. Or the Uruguay Round may fail, in which case an FTA should still be considered, and there could be a stronger argument in its favor.

III. Conclusion

This paper's principal aim has been to analyze the implications for a country in the LAC region of forming a free trade area with the United States. The emphasis has been on the interests of the LAC country—and not the United States or the world as a whole—and it has been concerned primarily with the hub-and-spoke case where the hub, the United States, makes bilateral agreements with the various spokes, the LAC countries. The analysis has distinguished the liberalization, trade diversion and reciprocity effects, and these have provided a convenient framework for considering the complex issues involved.

What, then, are valid conclusions?

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 Enterprise for the Americas Initiative has been greatly welcomed in the region. For any LAC country, the key benefit is to obtain an ensured open market in the United States. Of course, this depends on how open a particular country is already and what threats exist of the market's becoming more closed. It has to be noted that in general the U.S. market is already very open. The central focus of negotiations must be toensure that it is opened further, that the transition period is not too long, and that there are not too many exemptions, loopholes, and safeguards. Numerous detailed considerations that have only been

touched upon in this paper may 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 United States market for LAC country exports. But this paper has noted another aspect, namely, the changes in domestic policies—including subsidies, labor, and environmental regulations—that LAC countries 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. The liberalization effects of an FTA any country that wants to liberalize is free to do so, and several have already begun the process. 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, nearly 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 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. From the standpoint of political economy, liberalization may be politically easier to accomplish in some countries in the framework of an FTA than if 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 country, not trade diversion by the United States, the latter being beneficial for the LAC country and part of the reciprocity effect. This trade diversion effect is adverse but is likely to be important only if protection relative to outside imports remains high or may become high, possibly in response to shocks of various kinds, balance-of-payments problems, or 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 sufficient 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 LAC countries. For each, 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 LAC countries cannot have a very significant effect on international negotiations. The world environment is a given.

To summarize, because of the reciprocity effect, LAC countries 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 can provide. Various qualifications to these conclusions have been noted—including the need to change domestic policies to suit U.S. 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 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, 1974.

NORTH-SOUTH TRADE RELATIONS IN THE AMERICAS: THE CASE FOR FREE TRADE

Rudiger Dornbusch

Free trade in the Western Hemisphere is in the common interest of all participants. With benefits for all, the extension of NAFTA to the entire Americas is a priority trade initiative. Regional integration represents a parallel track strategy to the GATT process. GATT has served well in the postwar period, especially in the North Atlantic. It can yield additional benefits in the ambitious liberalization targets set in the Uruguay Round for agriculture, trade in services, dispute settlement, and intellectual property rights.

GATT explicitly recognizes regional free trade agreements as an exception to the MFN rules. Europe has taken advantage of that exception throughout the postwar period and has derived peace and prosperity from that strategy. And because the trade integration strategy has been so obviously successful, it is now being applied to the transition economies in the East. The United States can only gain from emulating the European precedent and example.

Today the United States has an unusual opportunity to implement an outward-looking trade policy with Latin America. Looking for modernization as the way out of a difficult economic situation, Latin America today is open to far-reaching trade reform. If we miss this opportunity, we are bound to fail building an important Western Hemisphere trade and investment bloc in the 1990s. Failure to act on trade opening means inviting a slowdown—if not failure—of the reform movement and a resurgence of protectionism throughout Latin America and beyond.

Democracy, workers' rights, safety, and environmental standards are obvious issues on the political agenda of modern, open economies. A free trade agreement supports modernization in the region and thus nurtures these objectives. It will also help raise wages back to their 1980 levels and beyond. By contrast, trade restrictions in the North will mean even more poverty in the South; and more poverty means fewer rights and a greater risk of political radicalism, neither of which is in the interest of the United States.

Regional Trade Arrangements and the GATT

Concerns about pursuing regional trade liberalization stem from fears about the dynamics of the multilateral trading system (MTS).[1] If the United States were to pursue a bilateral route and set up a preferential trade block, would there be a risk of the formation of other, competing block? And if that were to happen, could one be certain that there would not be a 1930s-style decline in world trade? Fieleke (1992) has rightly emphasized that four fifths of world trade is conducted *within* trading blocs: intraregional trade in the EC, EFTA, and the U.S.-Canada free trade agreement already account for 61

1. For discussion of the issue of regionalism and its development, see Lloyd (1992), de la Torre and Kelly (1992), Fieleke (1992), and Finger (1992). See also Park and Yoo and de Melo, Panagariya and Rodrik (1992).

percent of world trade, and various other groups make up the balance. Indeed, the expansion of world trade in the postwar period depended on the ability of regional arrangements to facilitate acceptance of otherwise difficult trade liberalization.

Opposition to regional approaches is to a great extent a negative reaction to the untried. But it also seems that the general principle of bilateralism appears far more offensive, and is more readily challenged, than any particular implementation, and more so when the United States sees itself as the custodian of a policy tradition of multilateralism it helped to create in the 1930s. The multilateral system has served well—and still does—but it certainly does not represent a unique and exclusive path to freer trade.

Until recently the policy debate in the United States has been hostile to regional trade arrangements or bilateralism. The status quo position of those who favor an open trading system is the GATT-based multilateral approach. Few among the protagonists of the status quo ask of the GATT process where the gains will be and when they come, if at all—negotiations take a decade or more. The beneficial effects of the status quo are taken for granted, and the only counterfactual is a world without trade.

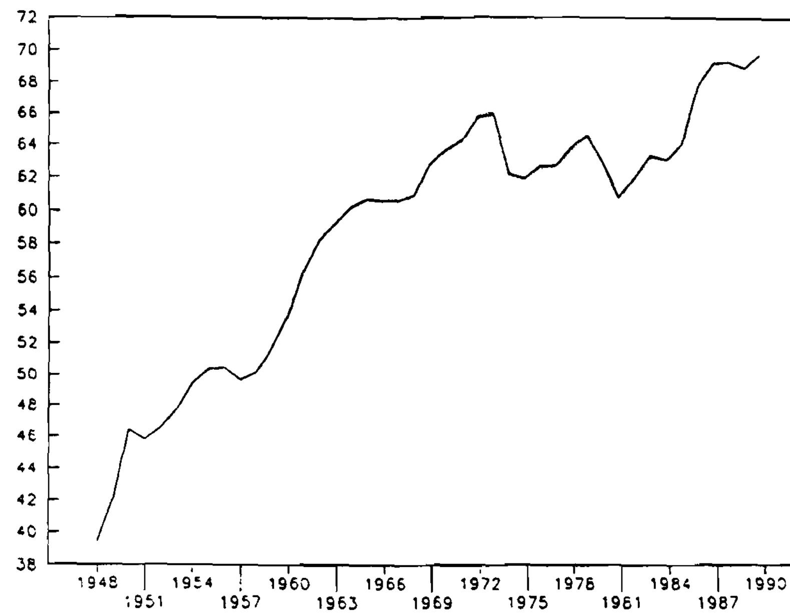
Regionalism (and even more so, bilateralism) has an unnecessarily bad name. The gains from the multilateral approach in the past have been significant and are not in question; but the pace at which the process delivers extra gains is slowing down. Moreover, trade policy initiatives in Europe and Asia are working quite possibly to the detriment of production located in the United States. In such an environment a search for a more effective U.S. trade policy assumes special importance. To reap the real income gains that freer trade can offer, the U.S. must not limit negotiations to the multilateral process.

Moreover, if the system is open in the sense of allowing conditional MFN access, a bilateral initiative can become a vehicle for freer regional trade. Regional initiatives move the world economy toward freer trade, complementing the MTS where it heads in that direction or filling a vacuum in the quest for freer trade in those areas where GATT has tacitly accepted the status quo or even a slide into protectionism.

In the past thirty years and the GATT notwithstanding, Europe has used regional approaches repeatedly, from the European Payments Union to the Common Market, EFTA, and the Europe 92 initiative. Few questions have been raised about the wisdom of that strategy, whether it amounted to deepening the extent of integration or widening the scope to include Greece, Portugal, North Africa, and Turkey. Developments in Eastern Europe offer the prospect that this region will soon enjoy preferred trade status with the Common Market, just as all of EFTA already does.

Europe's major regional effort negates any conceivable argument that a United States free trade bloc policy would undermine an otherwise intact MTS. The Europe 92 project so clearly foreshadows trade discrimination that the EFTA partners are scrambling to join it for fear of being left out in the cold. A U.S. policy of building a trade block is certainly not the first or even a decisive trespass on a system of more open trade. As Figure 1 shows, Europe's trade is 70 percent *intra*-European. No one would argue that the rapid growth of intra-European trade is the product of a destructive, inward-looking strategy. On the contrary, it is giving energetic support to the idea of trade liberalization.

Figure 1.
Intra-EC/EFTA Trade
(percent of total EC/EFTA Trade)



A Snapshot of the Americas

Here is a quick look at the region in terms of macroeconomic indicators.[2]

Table 1
Comparative Data: 1991

	Population (millions)	GDP (billion $)	GDP per capita ($)	Compensation ($/hour)
United States	253	5,678	22,443	15.45
Canada	27	574	21,259	17.31
Western Hemisphere[a]	450	1,000	2,222	
Brazil	153	418	2,732	2.55
Mexico	88	248	2,818	2.17

a. Estimate.
Sources: The World Bank, United States Department of Labor, and national sources.

2. The year 1991 was the most recent with complete GDP data for every country in the region at the time of writing.

The very first impression is the disproportionate weight of the United States. Even using the World Bank's ICP measures of per capita income, the discrepancy between North and South is still a factor of 4.[3] Canada, although rich in per capita terms, is not an economic giant compared to Latin American economies. In fact, Brazil is a close second. Third, the per-capita and wage discrepancies are of a factor of 10. The exact number does not make much difference: the fact is that the gap will last for many decades. Barro and Sala-y-Martin (1991) have studied the pace of convergence among regions. They conclude that the per-capita GDP gap between regions shrinks at the rate of 0.02 percent per year. Even if that estimate is pessimistic in view of the increasing possibilities of integration—this is no longer the U.S. North and South, without communications—there is no prospect of a near-equalization in 50 years. This point is important since it establishes that the regions are *starkly unequal* in their incomes.

The other point to consider is the state of trade integration. Table 2 shows some data on merchandise trade. Two facts stand out: first, Canada has virtually no trade with Latin America. Surely only the special dynamics of a free trade agreement will change that. Second, intra-Western Hemisphere trade is very small, and this fact raises the question whether North-South integration will substantially improve intra-Western Hemisphere trade integration. If regional schemes have failed, can a North-South deal do more? Third (not shown in the table) is the fact that more than half of the United States-Western Hemisphere link reflects the special relationship between the U.S. and Mexico. This fact immediately invites the question whether direct "neighborhood" effects have a very special role that cannot be equaled by simple free trade.

Table 2
Export Patterns, 1991
($ billion)

	U.S.	Canada	Western Hemisphere
To:			
U.S.	--	95.6	57.6
Canada	85.1	--	4.0
Western Hemisphere	63.5	2.4	21.0
World	421.8	121.2	140.4
Pct. of GDP[a]	7.0	24.2	13.6

a. 1989
Source: IMF, *Direction of Trade Statistics*

3. According to the World Bank's ICP measure of per capita real GDP, the United States in 1990 stands at $21,360, Canada at $19,650, Brazil at $4,750, and Mexico at $5,980.

Another point that emerges from the table is the relative closedness of the South as measured by the share of trade in GDP. This reflects substantially the closedness of the Brazilian economy. In part that is a characteristic of a large, diversified economy. But in part it is also a reflection of a very determined commercial policy in the past designed to keep out imports of manufactured goods.

Free Trade in the Americas: The Perspective of the United States

Several important trends in the world make pursuit of free trade agreements among the countries of North and South America an important, productive trade strategy. The arguments are first considered from the perspective of the United States.

- Latin America has the potential to be an important trading partner; yet its economies (for the most part) are still relatively closed. Except in Chile, the process of unilateral opening is just now getting under way, and the starting point is one of severe restrictions: huge tariffs, pervasive quotas, and impermeable permit systems. Consider, for example, tariffs in Argentina.

Table 3
Argentina: Average Tariff Rates
(Percent)

1976	1980	1989	1991
55.9	27.8	23.8	9.4

Source: GATT (1992)

Another measure of this closedness is imports per capita. In part, of course, they reflect the low level of income. But in part it is also as reflection of restrictive commercial policies. It is useful to bypass oil imports in countries such as Brazil. For that purpose we can look directly at trade with the United States. The contrast between Chile and Mexico, which have opened up, and Brazil and Argentina is striking.

Table 4
Imports Per Capita
($)

	World	U.S.
Argentina	244	69
Brazil	152	36
Chile	574	118
Colombia	172	65
Mexico	535	379
Venezuela	467	231
Korea	1,875	443
Turkey	335	39
Philippines	203	42

The counterpart of this closedness is that there are important markets which, if opened, would bring very substantial gains in productivity, and hence in living standards, in the course of trade reform. A clear demonstration is given by the (unilateral) Mexican trade liberalization in 1988. Within a single year, Mexican imports from the United States increased by $6 billion. That represents a larger increase than the entire prospective gain from the U.S.-Canadian free trade agreement.

- All of Latin America is reforming and modernizing in a way we have not seen since early in this century. The momentum, direction, and success of these reforms must be strengthened by a partnership that makes it difficult for Latin America to move back and delivers tangible benefits to offset the immediately visible costs of opening up. Having encouraged the modernization, it would be unwise for the United States to walk away from participation and partnership in the process.

- Regionalism has been a successful strategy in Europe throughout the postwar period, and it is now being driven at a far more ambitious pace. The merging of EFTA and the EC and the creation of a "European space" are already moving toward realization. An Asian co-prosperity sphere around Japan is also in the making.

Economic modernization demands a wider scope for economic activity, and the regional level offers the most concrete setting in which to visualize the benefits and hence find the willingness to make the concessions. These regional developments are not a threat to multilateralism; rather, they are a means to break down barriers on a limited regional scale and in so doing create precedents, blueprints, and competitive forces that will help drive a broader liberalization effort.

- Latin America represents a national security interest. If freer access to the U.S. market and less restriction on trade (at least from the United States) can help reduce the economic problems of Latin America, then a useful purpose is immediately served. It is appalling to imagine the risks of Latin America's falling into poverty and destitution like that in Haiti to recognize that there would be serious consequences, certainly in terms of migration, for the rich North.

With the spreading of democracy in Latin America, the United States has focused on deepening democracy and broadening trade policy to economic and special objectives including (in particular) labor standards and the environment. The opening and modernization of Latin America through trade and investment is a certain way to encourage the process and help shape the agenda. Limiting trade opportunities would not only set back modernization, but it would also certainly mean lower standards for workers and for the environment.

- Latin American also is the United States' fastest-growing market. Free trade with Latin America cannot solve the U.S.'s economic problems, but Latin America is still an important market, and the U.S. trade posture has important implications for Latin America's prosperity and hence U.S. security.

One must also bear in mind a longer-run perspective of Latin American markets. Latin America's population is almost twice that of the United States, and its economic growth will be substantial. If Latin America recovers economically (and the United States can certainly invest in that prospect), it will ultimately become a very significant market for U.S. exports.

To understand the prospects of an opening of markets in the South, Mexico's trade liberalization highlights two features. First, LDCs' markets are extraordinarily closed, and trade liberalization has potential for substantial increases in U.S. exports. The second point is that the first round of Mexican liberalization, even though it benefited overwhelmingly the United States, also allowed other countries to participate. A free trade agreement with Latin America would yield for the United States a privileged status.

It might be argued that Mexico's gains are already in place and there is little left for others. Of course, Brazil is far larger and offers a significant opportunity for increased trade over the next 20 years. It has a strong interest in unimpeded access to the U.S. market and offers an important market for U.S. exports. The current level of trade with Brazil is far below the country's market potential, as Table 5 shows.

Trade and Employment Effects

The controversy surrounding the FTA with Mexico, and surely an FTA with all of Latin America, is misplaced. Free trade with Mexico will not bring about "an economic and social disaster for U.S. workers and their communities," a view advanced by Thomas R. Donahue, Secretary-Treasurer of the AFL-CIO:

> The enactment of a free trade agreement with Mexico, as proposed by President Bush, would be an economic and social disaster for U.S. workers and their communities and [would] do little to help the vast majority of Mexican workers.

Table 5
U.S. Trade 1991
($ billion)

	Exports	Imports
World	421.8	509.3
Canada	85.1	93.7
Japan	48.1	95.0
Western Hemisphere	63.5	65.8
Mexico	33.3	31.9
Brazil	6.2	7.2
Chile	1.9	3.0

Source: IMF, *Direction of Trade Statistics*

Specifically, according to opponents, trade opening with Mexico and beyond would cause an immediate loss of jobs in the United States, further job displacement once investment in Mexico has established alternatives to U.S.-located production, and cause a decline in real wages in the U.S.[4] Any job losses are bad news at a time when real wages are depressed and employment is (at best) stagnant. But these issues must not become an argument for stopping a good move in trade policy that creates good jobs at home. The Clinton administration committed itself to the implementation of NAFTA, but organized labor and other groups opposing trade liberalization are far from accepting the situation.

Even if trade liberalization causes some dislocation, that must not freeze the United States into maintaining the status quo for the sake of poor jobs. It is bad trade policy to keep workers and their children in poor jobs and to pervert protection to the point where the U.S. attracts immigrants to perform this work. We should not let go of competition. But, equally important, displaced workers require adjustment programs, skill-building, and education to help them qualify for good jobs. The scope for worker training and adjustment assistance should be enhanced and broadened to include both trade- and productivity-related job losses.

Concerns about the effect of free trade on jobs in the United States focus on Mexico's low labor cost, far less than U.S. labor. But that would be true with or without free trade. Short of closing our economy, the U.S. will be unable to escape from the increasing ability of developing countries to produce manufactured goods at highly competitive prices. But the U.S. can turn the situation to its advantage by

4. For various perspectives see Koechlin and Larudee (1992), Blecker (1993), Faux and Lee (1992), Brown (1992), Leamer (1992), Office of Technology Assessment (1992), and Lustig, Bosworth, and Lawrence (1992).

gaining access to new markets. Table 6 illustrates the dramatic effect of the opening of Mexico for U.S. exports.

Table 6
United States Non-Oil Trade With Mexico and U.S. Job Creation
($ billion)

	U.S. exports	U.S. non-oil imports	Net non-oil trade balance
1986	12,391	14,040	-1,649
1990	28,375	25,206	3,169

Net U.S. Job Creation, 1986-90

30 Jobs per $1 million	25 Jobs per $1 million
144,531	120,450

Note: 30 jobs per $1 million exports is the number used by the Economic Policy Institute.

Several factors support the assertion that an FTA with Mexico cannot bring major harm and is very likely to be beneficial. First, Mexico is very small relative to the United States. Any significant increase in Mexican exports (measured on the U.S. scale) would increase labor requirements and wages in Mexico dramatically and thereby squash competitiveness.

Second, although Mexico's labor costs are low relative to those in the United States, these labor costs also reflect (in many cases) low productivity, and in areas such as textiles the very low quality of output. The quality factor especially is a major obstacle to a dramatic development of Mexico's exports.

Third, the United States has a very open economy. Competition from abroad is a reality. Protection continues only in a few sectors. Moreover, Mexico already enjoyed a privileged position both as a result of the GSP and—more important—as a consequence of the *maquila* program, which imposed U.S. duties only on the value added in Mexico. The combination of factors reduces the *extra* impact of U.S. trade liberalization to a few sectors and to a negligible total on aggregate employment and output. And the same is true for countries in Latin America.

In the 1980s, a vastly overvalued dollar caused abnormal import competition, job losses, and a reduction in real wages in the U.S. No doubt some of the competition came from Latin America and helps explain the 0.5-1.0 percent decline in real wages attributable to import competition.[5]

The remedy is not to close down trade and reverse liberalization, but rather to seek markets and create extra opportunities in manufacturing, which have a demonstrable positive effect on earnings. That has now already happened with Mexico, and more is to come as Mexico prospers in the 1990s; still more is to be gained from access to Brazil and other protected markets of Latin America. Aggressive pursuit of market access is the sensible strategy for a country like the United States, which is already open and does not wish to close.

Who is Ready?

Consider the argument that a free-trade agreement among unequals is a bad idea. A common objection to the free trade agreement with Mexico was, and will be even more so with other countries in the Americas, that they are not ready, their economies are too unstable, their politics insufficiently settled, or their standard of living too low. The argument has also been made from the South: Chile has argued that it *is* ready but other countries in the region are not.

The argument is appealing, but it lacks substance. The United States is interested in export markets and regional stability. Trade is already taking place with these countries, and nobody can possibly argue that existing trade restrictions, here or there, help make their economies or their societies function better. It *can* be argued, however, that substantial trade and investment links will promote freer, more stable, and more prosperous societies. Hence, particularly for economies where much is to be accomplished—notably Brazil—the possibility of an FTA raise the stakes and will enhance and accelerate reform. Nobody is thinking of political union or EC-style deep integration, for which a very high level of community is essential. What is at stake is the removal of impediments to trade and investment.

It is clear that institutionalization of reform and the spreading of a modern business culture (which is incompatible with closed, politically opaque societies) are fundamental objectives of the U.S. Indeed, they are a U.S. contribution to the region. Who needs it most? Clearly countries like Brazil stand to benefit more than Chile, which has already made significant progress. That is not an argument against free trade with Chile, it is an argument against singling out the most established and achieved economies for early treatment.

When Europe brought Portugal, Greece, and Spain into its fold, the purpose was to spread irreversibly democratic institutions and progress. That the venture was successful is beyond question. The same argument applies to Latin America, whether Venezuela, Peru, or Brazil be the case in point.

5. See also Brown (1992) and Faux and Less (1992) for the view that trade liberalization destroys jobs. For empirical evidence on wage effects, see Brauer (1991), Kosters (1991), and Revenga (1992).

How will the South Benefit?

The Americas need to take very seriously the need to review their medium-term economic strategies. In the United States the emphasis on education, skills, and investment moves in that direction. In the South some countries have made remarkable strides in moving to modern, stable economies. But that cannot be said of all: Brazil, for example, indulges reckless institutional and economic instability, as if these were the natural side effects of growing up. That is expensive: Asia is not waiting, as Table 7 makes clear.

Table 7
Economic Growth in Asia

	1971-80	1981-90	1991	1992	1993[a]
Asian NICs	9.0	8.8	7.2	6.4	7.1
S.E. Asia	7.7	5.5	6.4	6.7	7.0
China	7.9	10.1	7.7	10.8	9.2

Source: Asian Development Bank

In Latin America, by contrast, economic performance has a very poor record. There are growth spurts to be seen in Chile, Argentina, and Venezuela, but in fact only Chile has accomplished deep and lasting reform.

What role can trade integration play in improving reform and growth? Estimates of the South's benefits cover the gamut from enormous to nil. For Chilean policy makers, for example, an early free-trade agreement is seen as an essential step in a growth strategy. For Mexico's policy makers, the passing of NAFTA by the United States Congress was an urgent prerequisite for progress in stabilization and modernization. For other countries, the urgency seems much less. In Colombia, the view is common that trade integration should proceed first with Venezuela, and after that "training round," one might be ready for more. In Brazil trade issues have not gone beyond a general approval of unilateral trade liberalization with little trade strategy other than adherence to a GATT process.

Quantitative estimates of the trade benefits to Latin America are scarce. A study by Erzan and Yeats (1992) finds that the benefits would be minor. These authors conclude that where trade is not restricted by quotas, duties are low and trade is substantially unrestricted, at least for primary producing countries. By implication, these countries would stand to gain little from a free trade agreement. For manufacturing countries the presence of quotas and other nontariff barriers would be more of an issue. But even these hindrances might be passing in the context of the success of the Uruguay Round.

Table 8
Economic Growth in Latin America

	1981-91	1990	1991	1992[a]
Latin America	1.5	0.3	3.5	2.4
Argentina	-0.7	0.4	7.3	6.0
Brazil	1.7	-4.4	0.9	-1.4
Chile	3.4	2.0	5.8	9.5
Mexico	2.0	4.4	3.6	2.5
Venezuela	1.5	6.8	10.2	7.5

a. Forecast
Source: ECLAC

These minimalist estimates are worth noting, but there is no reason to believe that they give a realistic picture of the effects of an FTA. In part, of course, the trade effects derive from the immediate removal of barriers. In fact, however, the trade effects are much more sweeping when they come from an entire reorientation of the region to become a modern, outward-oriented, integrated part of the regional and world economy. In that broader sense, the move to an FTA represents nothing short of an upheaval.

A broader and more ambitious list of advantages includes removal of trade impediments, guaranteed market access, more assured modernization, and improved access to foreign direct investment.

- *Removal of trade impediments.* The point has already been made that there are relatively few impediments to trade and relatively low tariff barriers except in hard-core protection areas. There is, of course, the need to make a distinction between nominal and effective rates of protection. The escalation of duty rates by stage of processing means that value added in manufacturing where material content is substantial exceeds substantially the nominal rate. Even so, these are not formidable tariff barriers. Exemption from these duties will still yield an advantage, even for countries that already enjoy GSP treatment.

Table 9
Duty Levels
(Percent)

	U.S.	Canada
Raw materials	0.2	0.5
Semimanufactures	3.0	8.3
Finished materials	5.7	8.3

Source: *Economic Report of the President,* 1989

Trade restraints by quotas and voluntary export limitations are the more obvious area where large benefits might be accomplished—textiles, steel,and leather footwear are ordinarily high on the list, as are cheap glassware and certain agricultural products. There would be transition periods but ultimately markets would open, and with that opportunities would expand.

Of course, as these industries are opened to intra-FTA competition, the arguments for protection become weaker, and there is bound to be a parallel impetus for worldwide market opening. That diminishes the narrow benefits to the South but from a world point of view it reduces the discriminatory effects, which is all for the good and more so if it lies a decade or two in the future.

- *Guaranteed market access* is an extraordinarily important assurance. The status quo today is free trade, and that is likely to continue. But there is no assurance that this will in fact be the case. With the United States middle class squeeze and falling real wages, there is substantial pressure to close off trade wherever it hurts.[6] Thus, if there is a risk of the U.S. sliding into protectionism, an FTA creates a regional umbrella that protects against extreme damage.

The presence of such an umbrella has important consequences for business strategy. Without the assurance of market access, firms would have to be conservative in their growth strategy and could not in fact bank on the U.S. market. Being more prudent, they would limit their exposure and, as a result, their profitability. They would underinvest in trade expansion and hence the growth effects of modernization could be curtailed. By contrast, with assured trade access countries can take a regional view of their operation, merge across borders, and pursue a far grander strategy. This is where productivity gains become startlingly large and where the fixed costs of modernization are more easily amortized and hence more decisively incurred.

6. See Brown (1992) for an unfortunately influential view in this direction.

- *Modernization* is not a process that inevitably gathers momentum. Venezuela and Brazil have demonstrated how very precarious the process can be. It is therefore critical to muster all positive forces that strengthen the move toward modern, open societies and economies. One of these is clearly intercourse with the rest of the world. A free-trade agreement creates a very powerful momentum and, it may be argued, a quite irreversible one. The provision of open access in goods, services, and investment opens up a country's business institutions to international competition, and inevitably imposes international standards. People soon adapt and practice those standards themselves, and require them of others. Traditional, inefficient, and opaque ways of doing business come into conflict with modern ones.

In Mexico one can see quite clearly how this works. In less than a generation, the way of doing business has changed. More striking even is the example of Chile now colonizing Argentineans: Chileans have learned how to do business and the Argentines have not yet—Chileans are all over Argentina making deals, merging, buying, and brokering. Ten years ago no one would have thought that Chile could one-up sophisticated Argentina. But in fact they have, and one can only applaud.

Modernization has an important impact on business-government relations. Cumbersome and costly regulation encumbers competition and will be thrown off. Arbitrary government intervention makes firms uncompetitive: it will be done away with. Soon governments will perform by international standards. In a very real sense, a free trade agreement internationalizes an economy and in the process wipes out the hold of governments, monopolies, and restrictions on individual freedom and prosperity. The effect is often dramatic.

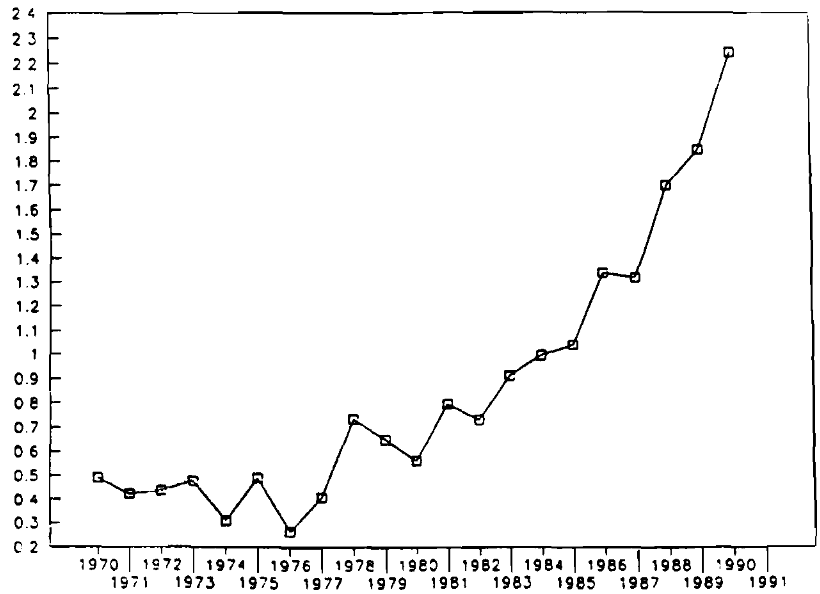
- *Foreign direct investment* serves several basic functions: First, they add to national saving in financing investment. Second, they give access to markets and technology, piggybacking on the scale or scope of the foreign investor. Third, they serve as a broad mechanism of business modernization.

It is clear that *some* foreign direct investment will go *anywhere*. But it is equally clear that steady and substantial flows require an institutionally stable situation. A free trade agreement provides exactly that. First, the specific provisions regarding financial services create an essential legal environment to assure foreign investors. Second, the assurance of institutional stability that comes with economic integration offers an important impetus for foreign investors to concentrate their attention on a specific country.

Two dimensions are particularly critical. One is market access. The decision to locate in a particular region comes with two questions: what are production costs in the region? And what is the market access from that region. On both counts, a free trade agreement is favorable. On the cost side, import liberalization is likely to reduce production costs. On the market access side, it offers assurance that there will not be random or systematic reversal of opportunities to sell into a partner country market, specifically the United States.

What evidence is there to show that foreign direct investment is attracted by trade integration? Spain serves as a case in point. Figure 2 shows direct foreign investment in Spain over the past 20 years. These flows were small in the 1970s. Only with the prospect, and then the realization, of joining the Common Market in the mid-1980s did FDI take off. By 1990, Spain received $11 billion in direct foreign investment, more than 2 percent of its GNP. The evidence is not totally rigorous: in the absence of a Common Market link, there would still have been some increase simply because of Spain's modernization. But even that modernization is at least in part the result of joining the Common Market.

Figure 2.
Foreign Direct Investment in Spain
(percent of GDP)



In sum, the South has far more to gain than the elimination of a few tariffs. In the process of historical change as substantial as the shift to inward-looking economies 60 years ago, free trade with the North is a powerful help.

Which Model for Integration?

Latin America has been trying to achieve trade integration within the region for a long time. It would be difficult to call the previous efforts successful. Perhaps because the benefits seemed too small, or because the protectionist philosophy of import substitution was still too prevalent, the efforts never took off. The Andean Pact or the Central American Common Market have had their ups and downs, and the new MERCOSUR is certainly not in the express lane, even though it is meant to lead to complete free trade by 1994.

The great difficulty in negotiating regional arrangements is finding a place to start. One position is defensive: try and string out protection, pile up exception lists, and let that dominate the process. The other mechanism starts from the end and views the transition regime as the price. This second approach establishes that after 10 or 15 years there will in fact be free trade, and the only issue is, how to get there. Superficially the mechanisms might seem to be the same; in fact they are radically different. One arrives after a decade at free trade, the other a decade later is dissatisfied with the concept of regional integration.

In larger groups the exception process is deadly. Trying to find the largest common denominator in a situation where many countries seek protection for the same industries means that the status quo will simply continue. An effective way to break the logjam is the adherence process to a mechanism that imposes as the rigorous sine qua non the terminal data for unrestricted free trade. The accession clause to NAFTA provides an effective mechanism to accomplish just that. This is not to say that NAFTA, viewed close-up, is pretty. In fact, the transition period is highly protectionist: for example, for 12 years there are severe restrictions on used-car imports into Mexico, for obvious reasons. But in the end, 10-15 years is a very short time, and free trade waits at the end.

A useful approach to Latin America would be to target the MERCOSUR group (Brazil, Argentina, Paraguay, and Uruguay) for a free-trade area, including (if possible) Mexico and Canada. Once the principle is accepted and the outline of an agreement is in place, other Latin American countries could join.

The dynamics of concluding an FTA are important because of the trade diversion aspect. It would be a mistake to have a long, drawn-out process with much uncertainty about who can or cannot join in the end. Trade diversion in the interim and a halt to investment pending clarification could create unnecessary problems for countries that ultimately may be members but are not in the early rounds at the negotiating table. This argument enhances the case for using NAFTA as a blueprint and for an early and short time window for other countries to join. Anything more than two years would be unnecessarily—and unproductively—long.

The fast-track approach is clearly the right way to proceed. Negotiations in any other setting are an invitation to cannibalize the agreements with exemptions and loopholes so that what is left in the end may not be worth having. The CBI—with its exception of sugar, textiles, and more—is a case in point. In a setting other than fast track, it is a foregone conclusion that politicians will have to seek "relief" and special advantages for their customers; they will be rewarded not by the end result but by the deviation from the norm that they can secure. The result, unfailingly, is a worthless agreement.

Even with the NAFTA in place, it must be made clear that Latin America should practice opening and clearing the trade field of the myriad obstacles still in place. Countries like Brazil have a lot of work to do in removing extensive tariffs and other controls on trade. Other countries—Chile and Argentina—are already far ahead.

The best approach is to focus on large blocks (the Mercosur is clearly the most interesting) and bring them in first, and quickly. For isolated countries—Chile or Costa Rica—a streamlined adhesion process without special provisions should be the rule.

Objectives

There ought to be a clear target on which no compromise should be allowed: anyone who wants to join must be ready to practice unrestricted free trade in goods, services, and investment with the partner countries by 2005. A successful FTA must make significant progress over and above what GATT has already delivered:

- Elimination of quotas and other nontariff barriers.[7]
- Full inclusion of all services in the liberalization process.
- Investment must be an integral part of the liberalization effort.

The review of the United States Advisory Committee (ACTN) of the U.S.-Mexico agreement offers a solid blueprint of just how ambitious the targets should be.[8] An important payoff is required to undertake changes in trade policy in addition to GATT. The only worthwhile payoff is a far more ambitious agenda than what is now being undertaken at the multilateral level.

Three Concurrent Processes

It is important to conclude by emphasizing the complementarity of three approaches: participation in the MTS, unilateral trade liberalization, and a Western Hemisphere Free Trade Agreement. The first is a worldwide strategy because a regional strategy alone will not suffice. Each country in the region has important extraregional interests and must take care that the world economy sustains open markets and broadens the opening of markets.

The WHFTA is critical because it carries trade liberalization much further than can be done at the world level: the coverage of liberalization—goods, services, and investment—is more substantial and the liberalization is more complete. For countries in Latin America and the Caribbean, becoming a part of it is essential in order to avoid concentrated trade diversion effects.

Unilateral liberalization is important in order to avoid the costs of trade diversion when one is an importer. If Brazil, for example, has 40 percent tariffs and grants the United States or Mexico zero-duty access, the scope for very costly trade diversion is substantial. The only remedy is to go quite far in the direction of unilateral liberalization. Since the FTA has a timetable of a decade, there is no need to rush unilateral liberalization. But it is essential to let the FTA and the unilateral moves go hand in hand to minimize unnecessary and undesirable trade diversion effects.

The three-pronged strategy described here is favorable for the world economy. Its results will be more trade, less protection, and hence greater scope for multilateral opening over time.

7. Congressional Budget Office (1991) provides an update on just how costly remaining U.S. hard-core protection is for the U.S. economy.

8. See Advisory Committee (1992).

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THE NORTH AMERICA FREE TRADE AGREEMENT: HEMISPHERIC AND GEOPOLITICAL IMPLICATIONS

Robert A. Pastor[1]

When Mexico's President Carlos Salinas de Gortari proposed to United States President George Bush a free trade agreement between the United States and Mexico, he shattered a national tradition. Since its revolution in the first decade of the twentieth century, Mexico has sought to maximize its autonomy by minimizing its relationship with the United States. Salinas's proposal represented a profound break with Mexico's past policies of economic defensiveness.

A regional trade agreement also represented a departure for the United States from its traditional global trade policy. That change first occurred when the United States responded positively to a proposal by Canada for a free-trade agreement. Salinas proposed to get Mexico into a new North American market. On December 17, 1992, the leaders of the three countries signed the North America Free Trade Agreement (NAFTA).

A steady process of integration between the three North American countries had led first Canada and then Mexico to recognize, albeit reluctantly, that their welfare depended on more, not less, economic interaction with their stronger neighbor, and on fair and predictable rules of trade and investment. Thus, NAFTA was not a decision to integrate but rather a decision to manage and enhance integration in a systematic fashion. As such, the agreement should be viewed not as the end of a negotiation but as the beginning of a long journey by the countries of North America to harmonize their policies.[2]

NAFTA was reshaped by the 1992 presidential campaign, and that reshaping had important long-term implications for the substance of trade policy. President George Bush viewed NAFTA as an issue because he understood that it placed his competitor in an awkward position. If Bill Clinton supported NAFTA, he would alienate the labor unions and the environmentalists, who supported him. If he rejected NAFTA, he could be called a protectionist, a liability in a presidential candidate almost as serious as being called weak on defense. Clinton postponed a decision, but on October 4, in a comprehensive speech, he announced support for ratification in the context of a changed policy. He proposed negotiating three supplementary agreements with Mexico and Canada on labor and environmental issues and on unforeseen trade problems. In addition, he insisted that five sets of policies should be included in the implementing legislation to ensure that the benefits of trade would be shared. The premise of the Clinton alternative was that NAFTA was good for all three countries but was not good for all groups in the countries, and special policies were needed to help those who would pay the price of freer trade. The election of President Clinton in November 1992 thus had the effect of changing the direction of U.S. trade policy.

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1. The author is grateful to Michael Discenza for assistance in collecting data and preparing the tables and figures.

2. For an extensive discussion of NAFTA and the new relationships that it will create, see Robert A. Pastor, *Integration with Mexico: Options for U.S. Policy* (New York: Twentieth Century Fund 1993).

While NAFTA will affect its three members the most, its impact will extend far beyond North America. Mexico's proposal sent shock waves so strong that ripples were felt in Chile as well as in Asia and Europe. Latin Americans had grown accustomed to Mexico's vetoing United States initiatives and asserting its separateness and independence. When Mexico's president opened the door of the U.S. market, he discarded the veto, and other Latin American governments hastily tried to get through the door and secure a place in the U.S. market as well. President Bush responded with the Enterprise for the Americas Initiative on June 27, 1990. The initiative promised to expand NAFTA if the other governments in the hemisphere opened their economies and liberalized their trade and investment as Mexico had done. The Clinton amendments will mean that environmental and social issues will be incorporated into the agenda of trade negotiations. The decision by the world's largest trading nation to pursue a regional agreement affected the entire world, but Europe was mainly preoccupied with the aftermath of the Cold War and the deepening and widening of the European Community. Japan was more dependent on the U.S. market than Europe was and than the U.S. was on Japan's, and it was acutely sensitive to the potential ramifications of NAFTA. Japanese manufacturers feared that North America could become an exclusive bloc and impede Japan's trade.

Some countries feared that NAFTA would lead, either directly or indirectly, to a collapse of the Uruguay Round of the GATT negotiations. The questions asked most frequently by economists and policy makers were whether NAFTA would be a stumbling block to global trade negotiations or a building block, and whether it would lead to a break-up of the global trading system or stimulate GATT to surmount the many obstacles in its path.

This paper will explore the hemispheric and global causes and consequences of NAFTA. The thesis is that NAFTA represents a crucial development for North America, the Western Hemisphere, and the world. NAFTA does not represent an exclusive trading *bloc* but rather the deepening of the last major trading *area* in the world: North America and eventually the Western Hemisphere. It is needed by the United States and the hemisphere because it comes at a moment when the GATT is languishing, unable to resolve the many tenacious issues on its agenda. Europe is turning inward, and Japan is increasingly oriented toward Asia. NAFTA will generate needed growth in Mexico, improve the efficiency of North American corporations, and lay the foundation for a new economic edifice that will benefit the three countries.

NAFTA's extension to the rest of the countries of the Americas could modernize political and economic relations within the Western Hemisphere, and it has the potential of making the Americas the center of the global economy and the model for North-South relations in the twenty-first century. Finally, at the global level, NAFTA could be a catalyst for expanding trade and improving the rules and institutions of the world trading system.

This is not to suggest that there won't be significant costs to NAFTA: there will be, as there always is with revolutionary change. Rapid growth entails dislocations and changes in the distribution of wealth. The issue for the three governments is to anticipate and respond effectively to those changes and ensure that the benefits of trade are shared with those who will initially suffer from NAFTA's progress. The issue is whether the United States, Canada, and Mexico are prepared to build the kinds of institutions that will reduce the risks, minimize the costs, and improve the prospects for sustainable growth and trade. That question remains to be answered.

To appreciate the significance of NAFTA, it is necessary to place it in historical and global context. In Part I, this paper discusses the theory of geopolitics and panregions and the relationship between geopolitical power and trade. It then describes the evolution of the post-World War II international economy and examines whether multilateralism is exhausted and whether regionalism is a threat or a stimulus to global trade. With this information as background, Part II describes the NAFTA agreement and the North American trading area. The hemispheric implications and choices that NAFTA poses are the subject of Part III, and Part IV offers recommendations on how NAFTA can (1) be sustained, deepened, and extended in North America; (2) stimulate freer trade and forge a democratic community in the Americas; and (3) solidify a more open and effective global trading system.

Geopolitics and Panregions: Theory and Reality

In the nineteenth century, German scholars developed the concept of "Geopolitik," a world divided by geography and politics into "panregions." The unification of Germany in 1871 and the new confidence that accompanied it gave rise to this idea. The premise of this world view was that powerful states needed *Lebensraum* (living space).[3] The new German state sought room to expand and ideas to justify its expansion. The debate on the proper physical and ideological path to expansion continued through the 1930s.

One model was that of the United States: a large, unpopulated territory and informal control in the Western Hemisphere and parts of the Pacific. Building on this idea in the 1930s, G. Haushofer, a German scholar, suggested that Japan and Germany should try to emulate this model, and he drew up maps that reflected three panregions: Europe and Africa with Germany at its center, East Asia with Japan as the dominant power, and the Western Hemisphere with the United States at its core. A fourth panregion composed of Russia extending west to Poland, east to the Pacific, and south to Afghanistan was noted in several studies of the period, but few German "Geopolitikers" considered the Russian panregion as powerful as the other three.

The twentieth century can be viewed as a multisided clash between the new powers of Germany, Japan, and the United States and the old empires of England, France, Austria-Hungary, Ottoman, and China. The major wars in this century—from the Russo-Japanese War through the two world wars and the many engagements of the Cold War—were a struggle to rearrange the world's geography by one or more of the three core nations. The explanatory power of the geopolitical theory is not only evident in the devastating wars but also in the fact that the three nations that arrived to challenge the world powers at the dawn of the twentieth century stand unrivaled at the century's close.[4]

The relationship between geopolitical power and world trade has never been disputed, although its precise nature has been subject to varying interpretations. It is obvious that world trade has never been organized at random: nations do not trade equally with others. Geography has been an important

3. For a survey of the literature on this subject, see John O'Loughlin and Herman van der Wusten, "Political Geography of Panregions," *Geographical Review*, Vol. 80, No. 1 (January 1990): 1-20.

4. For an articulate and informed examination of this three-sided struggle, see Jeffrey E. Garten, *A Cold Peace: America, Japan, Germany, and the Struggle for Supremacy* (N.Y.: Times Books, a Twentieth Century Fund Book, 1992).

factor explaining trade patterns, but until the post-World War II era of the General Agreement on Tariffs and Trade (GATT), it has been less important than politics. Trade followed the flag.

Empires were created and maintained to supply the resources and provide the markets for the imperial nation. In the cases of England and France, the empires were widely dispersed geographically, with colonies on many continents. The logic of politics prevailed over that of geography, as can be seen in the dominant role of France in trade in Indochina and England in Australia.

In contrast, the United States historically relied less on trade than other industrialized countries (Table 1), and it did not seek to carve Latin America into an exclusive trading zone. Until the First World War, U.S. trade with Latin America was often less than Europe's trade in the region. But the war separated Europe from the Western Hemisphere, and afterwards its devastating effect on Europe's economies compelled Britain, France, and Germany to retrieve overseas capital to pay debts and rebuild.

Table 1
Share of Exports in GDP, 1900-1990
(Percent)

	1900	1915	1930	1945	1960	1975	1990
United States	5.62	5.76	6.04	3.47	5.80	6.84	7.23
Canada	13.41	16.36	22.51	30.41	17.62	22.90	26.47
Mexico	17.51	22.92	12.40	14.09	10.34	5.77	17.63
Latin America	20.00	18.00	19.00	9.50	7.00	5.20	7.50
OECD	12.00	13.50	11.00	8.00	12.00	16.50	18.50
Europe							
United Kingdom	24.17	22.11	18.87	8.14	20.00	25.26	26.15
France	n.a.	n.a.	10.76	16.06	14.50	19.06	20.80
Germany	n.a.	n.a.	n.a.	11.32	18.99	24.80	25.41
Japan	n.a.	n.a.	19.43	1.02	10.71	12.80	11.18
World	9.00	12.00	7.00	6.50	9.00	13.00	14.50

Note: Data for the composite groups are estimated from the World Development Report, 1992.

At the same time, both the war and its aftermath caused the United States to concentrate its trade in the Western Hemisphere. Due to these two shifts—Europe inward and the United States southward—the United States emerged from the First World War with an exaggerated degree of economic dominance in the Americas. The U.S. share of the Latin American market grew from 18 percent in 1912 to 42 percent in 1920, and the United States went from being a debtor before the First World War to the world's largest creditor afterwards. Prior to the war, U.S. foreign investment in Latin America ranked considerably below Great Britain's. But by 1930, the United States had $5 billion of investments in Latin America—one third of its total overseas investments and more than the investments of European nations.[5]

The United States' self-image, however, did not readily adjust to world leadership. Indeed, the passage of the Smoot-Hawley Tariff of 1930 was yet another example of U.S. insularity. It raised U.S. tariffs on more than 20,000 products to an average of more than 50 percent, and President Herbert Hoover defended tariffs as "solely a domestic question in protection of our own people."[6] The law exacerbated the U.S. economic depression and further weakened world trade. Cordell Hull, the Secretary of State in Franklin Roosevelt's administration, was a devoted free-trader, and he marshalled support in Congress for the Reciprocal Trade Agreements Act of 1934, which delegated to the president authority to reduce tariffs by reciprocal trade agreements with other governments. The new trade policy became a key element of Roosevelt's Good Neighbor Policy. Sixteen of 22 trade agreements negotiated by the Roosevelt administration were with Latin American governments.

The effect of the Second World War on the magnitude and patterns of trade and investment in the Western Hemisphere was similar to that of the First World War. The United States and Latin America were drawn closer together as European markets closed, and after the war Europe was immersed in reconstruction. In 1945, 58 percent of Latin America's imports came from the United States, and 49 percent of its exports went to the United States. Latin America also become more important to Washington. In 1945, 42 percent of U.S. imports came from Latin America, and 14 percent of its exports went there.[7]

During World War II, U.S. policy makers began to contemplate involving Europe in global free-trade agreements that would require breaking up prewar trade blocs by our allies as well as by our enemies. The price that the United States extracted from Great Britain in exchange for lend-lease agreements in World War II was an end to imperial preferences and acceptance of a nondiscriminatory, reciprocal trading system based on most-favored-nation status.[8]

The principle of nondiscrimination became the centerpiece of the General Agreements on Tariffs and Trade, signed by 23 countries in Geneva on October 30, 1947, under the leadership of the United

5. Joseph S. Tulchin, *The Aftermath of War: World War I and U.S. Policy Toward Latin America* (New York: New York University Press, 1971), pp. 38-79; Albert Fishlow, *The Mature Neighbor Policy: A New United States Economic Policy for Latin America* (Berkeley: University of California Institute of International Studies, 1977), pp. 3, 7, 12.

6. William Starr Myers and Walter H. Newton, *The Hoover Administration: A Documented Narrative* (N.Y.: Charles Scribner's Sons, 1936), pp. 493-495. For a review of Smoot-Hawley and the evolution of U.S. trade policy, see Robert A. Pastor, *Congress and the Politics of U.S. Foreign Economic Policy* (Berkeley: University of California Press, 1980), Part II, pp. 67-200.

7. Joseph S. Tulchin, *The Aftermath of War: World War I and U.S. Policy Toward Latin America* (New York: New York University Press, 1971), pp. 38-79; Albert Fishlow, *The Mature Neighbor Policy: A New United States Economic Policy for Latin America* (Berkeley: University of California Institute of International Studies, 1977), pp. 3, 7, 12.

8. Richard N. Gardner, *Sterling-Dollar Diplomacy: Anglo-American Collaboration in the Reconstruction of Multilateral Trade* (Oxford, England: Clarendon Press, 1956).

States. World trade has expanded more rapidly than world production virtually every year since 1947, thus enhancing global interdependence.

Together with decolonization, the GATT rearranged global trading patterns around panregions, reflecting the importance of geography.[9] Between 1960 and 1980, Japan became the leading trading partner in most of non-Communist Asia; the Federal Republic of Germany became the trading center of Europe; and the United States was dominant in the Western Hemisphere. Two scholars of geography summarized the overall effect of these changes: "While the technical impediments to trade over long distances have largely been overcome, intense (macro-) regional trade relations, mainly shaped by a limited number of dominating centers, are becoming an increasingly salient feature of the global trade map."[10]

Evolution of the Global Trade System

In theory, GATT was multilateral and nondiscriminatory; in practice, the United States made mostly unilateral concessions in Geneva and in subsequent trade negotiations in order to allow Europe and Japan time to recover economically. That was the price of leadership, and some have argued that without paying such a price, the world economy would not have recovered and the global economic institutions—the International Monetary Fund, the World Bank, and the GATT—would not have been established.[11] But by 1962, Europe had recovered and the dollar was under pressure. The United States demanded reciprocity.

President John F. Kennedy obtained authority from Congress to pursue a new round of trade negotiations to achieve that purpose. The Kennedy Round concluded on June 30, 1967, with 46 nations agreeing to reduce the average tariff for industrialized countries to a point—about 9 percent—where it ceased being an impediment to trade. From 1946 to 1967, U.S. exports tripled, from about $10 billion to about $31 billion, and world trade nearly quintupled, from about $55 billion to about $235 billion.

Tariffs continued to decline to less than 5 percent by 1990. By then, the agenda of trade negotiations had changed. The principal issue became nontariff barriers, which Robert Baldwin defines as "any measure (public or private) that causes internationally traded goods and services, or resources devoted to the production of these goods and services, to be allocated in such a way as to reduce potential real world income."[12] What this entails is virtually every domestic or regulatory policy—anything that

9. T. Nierop and S. de Vos, "Of Shrinking Empires and Changing Roles: World Trade Patterns in the Postwar Period," *Tijdschrift voor Econ. en Soc. Geografie* (Amsterdam, Netherlands), 79, Nr. 5 (1988): 343-364.

10. Ibid., p. 362.

11. This is the theory of hegemonic stability - that global powers pay a price of leadership to build and maintain the international system. See Charles P. Kindleberger, *The World in Depression, 1929-1939* (Berkeley: University of California Press, 1973); and Robert O. Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton: Princeton University Press, 1984).

12. Robert E. Baldwin, *Non-Tariff Distortions of International Trade* (Washington, D.C.: Brookings Institution, 1970), pp. 2-5.

would confer an advantage on an import or a disadvantage to an export. Safety, health, labor, or environmental standards; services; intellectual property rights; agricultural subsidies; investment restrictions; tax incentives or liabilities; discriminatory procurement procedures—these and others become subject to negotiations.

It is not surprising that these issues have proven to be far more difficult to negotiate, particularly in forums with more than 100 countries. The Uruguay Round of trade negotiations began in 1986 to deal with the new agenda of services, agriculture, textiles, intellectual property rights, trade-related investment measures, and dispute-settlement mechanisms, all issues that had been too difficult to address, let alone resolve, in the past. Although the Uruguay Round was supposed to end by December 1990, it was still far from finished by January 1993. Part of the problem was the complex agenda. Many of the nontariff issues were hard to grasp technically and quite sensitive politically.

Another reason for the stagnation of the GATT was the relative decline of the economic power of the United States. Germany overtook the United States as the world's premier exporter in 1990, and while the United States regained the lead in 1991, the point is that no nation—neither the United States, Germany, nor Japan—had sufficient power to lead the GATT to closure.

The slide in U.S. leadership was evident in its change from creditor to debtor status. During the 1980s, trade deficits increased to over $100 billion: this shift put severe strains on U.S. manufacturers and evoked new calls for protection. The dollar sank in value relative to both the deutsch mark and the yen, but the U.S. trade deficit remained chasmic. Fiscal deficits were two to four times larger than the U.S. trade deficit and constrained Washington's interest in acting as the global leader.

Universalism versus Regionalism

The relative weakening of the economy of the United States coincided with other changes in the hemisphere and led to the first policy dent in the global armor of U.S. foreign economic policy. In 1982, partly because of scarce resources for aid but mostly because of security concerns about leftist influence in the Caribbean Basin, President Ronald Reagan turned to trade policy as an instrument for combatting leftist subversion. He proposed granting one-way free trade on a wide range of products from countries in the region. The countries were so small and the motive was so patently strategic that no major nation protested, but the significance of the act was not lost on those who viewed a global trading system as sacrosanct. The next exception occurred in the free-trade treaty with Israel in 1985, but for the same reasons, no concerns were raised.

In 1986, the European Community (EC) decided to attempt creation of a single common market with no internal barriers to trade, investment, travel, and immigration, all within six years. The United States had been one of the principal sources of encouragement to the Europeans to unite. The real genius of the Marshall Plan was not the $17 billion in aid but the condition that Europe could obtain the aid only if it developed a common plan that promoted regional cooperation. Through a series of steps, France and Germany and later five other European nations forged new institutions and bonds that paved the way for the creation of the European Economic Community (EEC) with the signing of the Treaty of Rome in 1957.

The United States accepted a provision in GATT—Article XXIV—that allowed for exceptions in cases of customs unions or free-trade areas, provided the preferential trade reductions for the group were eventually to eliminate all barriers to trade within the subset of countries. Two difficult questions were posed by the EEC. First, it was by no means certain that *all* barriers to trade would ever be eliminated and, indeed, 36 years later barriers still remain. Second, the EEC insisted on discriminatory preferences for 18 ex-colonies in Africa; this also violated the GATT. Nonetheless, the United States promoted the EEC's application under Article XXIV because of the larger goal of promoting European cooperation and security, and it never deviated from its support of European integration despite the fact that the region had become a formidable competitor in world trade.

But the deepening and widening of the EC in the late 1980s coincided with serious economic troubles in the United States. The result was that the nations of North America began to look to each other to build a regional trading area. First, Canada proposed a free-trade agreement with the United States, and that came into effect in January 1989. Given the magnitude of the trade between the two countries—the highest between any two in the world—this exception was taken seriously. Within 18 months, Mexico decided to join this broader trading community.

The end of the Cold War played a role in the movement toward regionalism. Indeed, it had an effect on United States-Latin American trade similar to that of the end of the two world wars. The degree of U.S. dominance in Latin American trade declined sharply between 1950 and 1980. But from 1986 to 1991, as the Cold War wound down, the United States increased its market share of OECD exports to Latin America from roughly 50 percent to 58 percent. [13] As in the previous cases, the change had less to do with the war, hot or cold, or U.S. policy than it did with European self-preoccupation. That was the point of departure for NAFTA. The idea of a free trade area for North America was hardly new: it has often been proposed by American academics or politicians, but just as often rejected by Mexico. What made NAFTA possible was that a Mexican president proposed it. Although his main motive was to enhance Mexico's development, an important factor was the way the world was organizing itself.

Salinas went to Europe in early 1990 to encourage investment in Mexico, but Europe was focused on deepening the European Community by 1992, considering a widening of the EC to include Scandinavia and Eastern Europe, and sorting through the implications of the end of the Cold War. When he turned next to Japan to offset U.S. investment, he found the Japanese hesitant for two reasons. First, they were devoting much of their external energies in Asia—investing in China and Southeast Asia, trying to expand their markets there, and developing the yen as an alternative currency. Second, Japan's most important alliance and market was the United States, and Japan knew the relationship between the United States and Mexico was awkward. Japan apparently decided not to get too close to Mexico for fear it would create problems with its more important ally. It was only when Salinas realized that the European and the Asian options were closed that he turned to the United States.

When the Cold War ceased, world power shifted as much as it had after the two world wars. Russia declined to the economic level of the third world, and the United States found itself competing on a new economic chessboard against Japan and a unified Germany anchored in a wider and more integrated European Community.

13. U.S. Agency for International Development, *Latin America and the Caribbean: Selected Economic and Social Data* (Washington, D.C., April 1992), p. 171.

The apparent trend toward regionalism has raised questions both about which country is most responsible and whether the trend is beneficial or protectionist. In the judgment of Jagdish Bhagwati, "the main driving force for regionalism today is the conversion of the United States.... As the key defender of multilateralism through the postwar years, its decision now to travel the regional route (in the geographical *and* the preferential senses simultaneously) tilts the balance of forces away at the margin from multilateralism to regionalism."[14] Bhagwati also finds the trend worrisome and unfortunate.

The Economist blames the EC as the principal culprit in the trend toward regionalism and protectionism and argues that "America has resisted [the protectionist logic] better than most.... In miserable contrast, the European Community has written the book on new methods of protection."[15] Lawrence Krause agrees that the EC represents "a huge exception to a nondiscriminatory [international trade] regime."[16] Brunelle and Deblock agree that "if the fortress metaphor applies, it should be used to describe the EEC since over 58 percent of its total trade was done among the 12 member countries in 1987."[17] To advance towards its 1992 deadline for achieving a completely open market, the EC has had to make internal political compromises at the expense of the region's international obligations. The EC's inability to adapt its Common Agricultural Policy has had the effect of closing the European market to many of Latin America's crops and scuttling the GATT negotiations.

The consequences for world trade of the trend toward regionalism depend on whether the EC's example—unity at the price of protectionism—proves the rule or the exception. In his classic study of customs unions, Jacob Viner argued that regional trading units are beneficial if they create more trade than they divert *over the long term*. Part of the problem is in determining how long is "long-term" and how to estimate the amount of trade created or diverted. But regionalism can also be beneficial to world trade if the new units develop formulas for dealing with the new trade agenda that could be tested and, if successful, used eventually by GATT. Some have suggested that the formulas devised by the United States and Canada for dealing with services and dispute settlement could be extrapolated to GATT.

The answer to the question whether the regionalist trend is good or bad for world trade thus depends, in large part, on the evolution of these units and whether they become exclusive trading blocs or platforms for more internal and external trade.

14. Jagdish Bhagwati, "Regionalism and Multilateralism: An Overview," Discussion Paper Series No. 603 (New York: Columbia University Department of Economics, April 1992), p. 12.

15. *The Economist,* June 27th 1992, p. 13.

16. Lawrence B. Krause, "Regionalism in World Trade: The Limits of Economic Interdependence," *Harvard International Review,* Summer 1991, p. 4.

17. Dorval Brunelle and Christian Deblock, "Economic Blocs and the NAFTA Challenge," summary of work carried out by the Research Group on the Continentalization of the Canadian and Mexican Economies, University of Quebec in Montreal, May 2, 1991, p. 6.

North America: The Agreement and the Entity

The NAFTA agreement signed by Presidents Bush and Salinas and Prime Minister Mulroney on December 17, 1992, is a massive document that aims to reduce trade barriers at varying speeds in different sectors. The agreement will go into effect in January 1994, but it will be phased in over 15 years to give additional time for "sensitive" industries and farms to adjust to increasing competition. NAFTA was innovative in a number of areas, including promoting the harmonization of environmental pollution standards, eliminating quotas on textiles and apparel, creating free trade in services (including the very large telecommunications sector and the insurance market), and guaranteeing total market access in agriculture after the 15-year transition period.[18]

The Agreement

NAFTA provides for the progressive elimination of all tariffs, although most will be eliminated in 1994 or within five years. Tight rules of origin will prevent Mexico from being used as an export platform. In agriculture, the three governments agreed to eliminate all the quotas and quantitative restrictions and 50 percent of the tariffs in 1994. In some cases, tariffs will be replaced by tariff-rate quotas. The agreement relaxes most restrictions on investment except in the energy sector in Mexico and the cultural sector in Canada, and it establishes an advanced regime to protect intellectual property rights. The North American Trade Commission deals with disputes.

Because the debate in PRI-dominated Mexico and parliamentary Canada was a foregone conclusion, the debate in the United States Congress became the principal forum for addressing NAFTA and particularly for the social, political, environmental, and economic agenda that remained outside the agreement. From the spring of 1991, when the Bush administration requested fast-track negotiating authority through the ratification of the agreement, it sometimes appeared that the United States drove the wider agenda, but what was actually occurring was that groups from all three countries were using the Congressional forum to pursue a shared agenda. President Clinton later incorporated that agenda into his own.

This wider social, environmental, and political agenda reflects a change in public attitudes in all three countries in North America. Ronald Inglehart of the United States, Neil Nevitte of Canada, and Miguel Basañez of Mexico conducted surveys in all three countries at the beginning and at the end of the 1980s, and they found that attitudes are not only similar, but they have also been converging in a way that makes further integration more feasible.[19] In all three countries, public attitudes increasingly support political liberalization, free market (but *not* laissez-faire) economic policy, and a higher priority for autonomy and self-expression in all spheres of life. The authors believe that the main cause of the convergence in value systems is that young people in all three countries are better educated and more

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18. For a detailed analysis of the agreement and its estimated impact, see Robert A. Pastor, *Integration with Mexico,* Chapter 3.

19. Ronald Inglehart, Neil Nevitte, and Miguel Basañez, "Convergence in North America: Closer Economic, Political, and Cultural Ties Between the United States, Canada, and Mexico." Manuscript, 1992.

influenced by global communications: "A narrow nationalism that had been dominant since the nineteenth century is gradually giving way to a more cosmopolitan sense of identity."[20]

Even as a North American orientation emerges, people in all three countries retain a certain parochialism. *The key to dealing with the current and future agenda is recognizing that both inward and outward impulses are in a delicate balance, and the words and actions of one country can reinforce their mirror image in another.* When a politician in the United States gives vent to the fears of people in California coping with massive waves of immigrants, such harangues are heard in Mexico City, and politicians there are likely to play on the insecurities of their countrymen about being treated unfairly by the United States. Some Mexicans might complain about U.S. corporations taking over their industries and insist that their government prevent a loss of Mexico's identity. Such xenophobia is hardly unique to Mexico; the reaction by Americans to Japanese takeovers is cut from the same cloth. The point is that fears in one country reinforce fears in the other. Unless leaders or institutions step between the cycle of fear and describe the grounds for hope, the possibility always exists for a retreat from integration.

Theories developed using the Western European experience suggest that increased economic interaction does not lead to integration and political community *unless* there is an increase in trust and of shared experiences that reinforce positive feelings toward each other.[21] Polls in North America indicate that there is a high level of trust between the United States and Canada, a slightly lower level by these two with Mexico, but Mexicans are more likely to distrust Americans than trust them. Nonetheless, the experience of Europe shows that distrust can erode, as it did between the French and the Germans from the 1950s to the 1970s, as a result of working together in the European Community.

In the case of North America, national historical experiences caused both Canada and Mexico to prefer distant relations, but the Inglehart study discovered that those feelings have undergone a fundamental change. By 1990, both Canada and Mexico were more inclined to *support* freer trade and closer ties with the United States than to oppose it. "To an astonishing extent, these traditional forms of nationalism seem to have vanished."[22] What replaced it is a cooperative realism; over 80 percent of the public in all three countries favor freer trade provided it is fair and reciprocal; only 15 percent oppose it.[23]

The North American Entity

North America constitutes a formidable region. Its population has grown dramatically since 1950 to a combined total in 1990 of 362 million. Immigration has been an important cause of the rise in population in the United States and Canada, and improved health care has been the primary cause in Mexico. Although the rate of population growth in Mexico has declined precipitously since it introduced

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20. Inglehart, Nevitte, Basañez, *Convergence*, Chapter 1, p. 1.

21. See particularly, Karl W. Deutsch, et. al., *Political Community and the North Atlantic Area* (Garden City, New York: Doubleday, 1968).

22. Inglehart, Nevitte, and Basañez, *Convergence in North America*, Chapter 2, p. 15.

23. Ibid, Chapter 2, p. 12, Figure 2-3.

family planning in 1974, its population growth is still about twice that of its two northern neighbors. The result is a much younger population in Mexico, but complementary profiles with the U.S. and Canada. In 1990, over 36 percent of Mexico's population was less than 15 years old, compared to less than 20 percent in its two northern neighbors (Table 2).

The gross product of the three countries grew by a factor of more than ten, from roughly $560 billion in 1960 to $6.2 trillion in 1990 (in current dollars). The region's exports grew even faster, from $60 billion in 1970 to $587 billion in 1991, and intraregional trade as a percentage of the global exports of the three increased from 37 percent to 42 percent during the same period. The United States captures the lion's share of the trade and the market, even though its dependence on its neighbors is a small fraction of their dependence on it. Both Canada and Mexico conduct between two thirds and three quarters of their global trade with the U.S., whereas the U.S. conducts a total of about one quarter of its global trade with its two neighbors. Their combined intraregional trade represents about 40 percent of their total, compared to about 60 percent for the European Community. In 1990, the per capita GNPs of the United States and Canada were comparable, $21,790 and $20,470, respectively, but Mexico's was roughly one tenth that amount (Table 3).

Hemispheric Implications

Latin America's motive in wanting to join a wider trade area with the United States is similar to Mexico's: fear of exclusion. Fear has always been a more powerful motive than hope, particularly one as vague as joining a larger trading community. The trends in Latin America worsened demonstrably during the "lost decade" of the debt crisis. In 1955, nearly 20 percent of all U.S. imports came from South America; by 1990 that total declined to about 5 percent, and imports from the Caribbean fell from 6.6 percent to 1.6 percent.[24] North American trade became more concentrated, and the rest of Latin America was slipping away and sinking. In 1989 and 1990, half of U.S. trade with Latin America was with Mexico. Failure to secure the U.S. market could mean marginalization.

The Enterprise for the Americas Initiative (EAI) promised free trade agreements to hemispheric governments that implemented market reforms. The United States government gave priority to NAFTA, but it advised interested Latin American governments to prepare for future talks by accelerating subregional integration schemes and negotiating framework agreements similar to the U.S.-Mexican agreement of 1987.

Salinas pursued a similar approach to his neighbors. He offered the Central American governments a free trade agreement, sought and received associate membership in the Caribbean Community, and on July 20, 1991, joined with the presidents of Venezuela and Colombia to propose a three-way free trade zone to take effect in January 1992, a deadline that proved overambitious. By late August 1992, the three governments had failed to agree to a timetable, and questions arose as to how it would be affected by NAFTA. In the meantime, however, in January 1992 Colombia and Venezuela adopted zero tariffs for their bilateral trade and were pressing their Andean partners to accelerate the

24. This and the following data is from the U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States*, various years.

Table 2

North America: Population and Profiles

Population	(Millions) 1950	1970	1990	2000
North America	192.29	277.55	362.70	400.27
U.S.	152.27	205.05	250.00	268.27
Mexico	26.28	51.18	86.20	103.00
Canada	13.74	21.32	26.50	29.00

	Under 15 (%)				*16-60 (%)*				*61-over (%)*			
% Distribution	1950	1970	1990	2000	1950	1970	1990	2000	1950	1970	1990	2000
U.S.	26.87	28.26	21.57	19.70	58.25	57.71	61.20	62.50	14.88	14.04	17.22	18.20
Mexico	45.60	46.50	36.50	25.00	49.30	50.00	60.50	66.00	5.10	3.50	3.00	9.00
Canada	33.50	30.20	21.40	19.30	58.20	61.90	68.60	63.50	8.30	7.90	10.00	17.20
North America *(average)*	35.32	34.99	26.49	21.33	55.25	56.54	63.43	64.00	9.43	8.48	10.07	14.80

Note: U.S. data for the year 2000 are projections from the U.S. Bureau of the Census; projections for Canada and Mexico are based on World Bank estimates.

Sources: U.S. Department of Commerce, Bureau of the Census, "Statistical Abstract of the U.S.," 1991; and The World Bank, "World Tables," 1984 and 1991; and "World Tables-Social Data," 1984; and "World Development Report," 1992.

Table 3

North America: Economic Indicators

	GNP ($Bil - Current) 1960	GNP 1980	GNP 1990	GNP per Capita ($ - Current) 1960	GNP per Capita 1980	GNP per Capita 1990	Exports Customs Basis, fob ($Mil - Current) 1960	Exports 1980	Exports 1990		Imports Customs Basis, cif ($Mil - Current) 1960	Imports 1980	Imports 1990	
U.S.	508.8	2,732.00	5,447.50	2,811.05	11,982.46	21,790.00	20,600	216,920	371,466		15,072	250,280	515,635	
							24.96%	*22.89%*	*28.32%*	*	*30.81%*	*21.34%*	*24.10%*	*
Mexico	11.98	188.74	214.64	323.13	2,680.34	2,490.02	1,245	15,308	26,714		1,515	19,517	28,063	
							59.04%	*65.49%*	*71.10%*	*	*64.78%*	*63.38%*	*66.24%*	*
Canada	39.28	258.17	542.46	2,193.45	10,737.88	20,470.19	6,573	63,105	125,056		7,031	62,838	115,882	
							63.45%	*61.25%*	*75.82%*	*	*65.12%*	*68.02%*	*64.12%*	*
North America	560.06	3,178.91	6,204.60	1,775.88	8,466.89	14,916.74	28,418	295,333	523,236		23,618	332,635	659,580	

*Notes: * refers to the percentage (%) of trade within North America; and North American GNP per Capita is an average of the three countries.*

Sources: The World Bank, "World Tables," 1984, 1991; and "World Development Report," 1992; and OECD, "Monthly Statistics on Foreign Trade," July 1992; and International Monetary Fund, "Direction of Trade Statistics Yearbook," 1992.

integration of their pact.[25] Salinas signed a free-trade agreement with Chile's President Aylwin (it was implemented in January 1992), and he agreed to begin negotiations with the governments of Central American countries aimed at a free trade agreement by 1996. In the meantime, the Central Americans began discussions with CARICOM on a free trade pact.

Latin America embraced the Enterprise for the Americas Initiative and Salinas's example. Subregional trading groups, including old ones like the Andean Pact and new ones like MERCOSUR, experienced more serious consideration and made more progress since 1990 than they had for decades. In 1991 alone, trade within MERCOSUR grew by more than 40 percent, and within the Andean Group by 35 percent. [26] By 1992, the United States signed 16 trade and investment framework agreements with 31 countries in Latin American and the Caribbean.

The most surprising and exuberant response came from Latin America's other nationalistic guardian, Peronist Argentina. Argentine President Carlos Menem lavished praise on the new approach to tighten United States-Latin American economic relations: "We consider this [the Enterprise Initiative] not as a proposal of a philanthropic nature, based on a false paternalism. Nor does it grow out of strategic military considerations. On the contrary, it is an ambitious business proposition. Latin America is considered this time as a new entity, as a valid interlocutor able to talk in terms of mutual interests."[27]

An economic logic lurks beneath the movement toward hemispheric integration, and in some ways the 1990s resemble the 1930s when the United States and Latin America turned to each other for bilateral trade in the face of a world broken into trading blocs. The United States has found it hard to penetrate Japan, and Latin America has found similar problems exporting to a self-absorbed Europe. As in the 1930s, the United States and Latin America have discovered a commonality of economic interests, but unlike that period, neither has an interest in withdrawing from the world today. What the hemisphere lacks is a strategy of helping each other while prying open the GATT.

Just five years ago, the idea of a hemispheric option would have been inconceivable. Burdened by debt, brutalized by military dictators, defiant of or disgusted with the policies of the United States, much of Latin America was no partner for the United States. Gradually, the old presuppositions are falling. A new image of modern, democratic technocrats is taking hold. Free, contested elections have been held in every country in South America, Central America, and all but Cuba in the Caribbean. There have been setbacks in Haiti, Peru, and Venezuela, and other countries like El Salvador, Guatemala, and Bolivia continue to struggle with despotic demons of their past. But democracy is wider (if not deeper) than ever before, and the new democracies are groping on the frontier of an old order of sovereign states to devise collective mechanisms to defend each other from authoritarian reversals. In this, the region is unique.

Economically, most governments have laboriously constructed new and firm macroeconomic bases. Hyperinflation has been brought under control; debt service as a percent of GNP declined from 64.3 in 1987 to 37.4 in 1991; capital is returning in large amounts, and the region's economies have

25. "Slower Pace for Subregional Groups," *Latin American Weekly Report,* 10 September 1992, pp. 6-7.

26. "Free Trade and Common Markets," *Latin American Special Reports,* June 1992, p. 1.

27. Ibid.

begun to grow, 2.8 percent in 1991, the first positive change since 1987. From 1986 to 1991, the United States doubled its exports to $63 billion and its foreign direct investment to $72 billion.[28] With serious political problems and weak and vacillating macroeconomic policies, Brazil has been an exception to this trend, but when its engine restarts, it will pull all of South America forward at an accelerating clip.

At the very end of the long NAFTA text—Chapter 22, Article 2205—sits a very brief and vague "accession clause":

> Any country or group of countries may accede to this Agreement subject to such terms and conditions as may be agreed between such country or countries and the Commission and following approval in accordance with the applicable procedures of each country.

This accession clause merely begs the question as to how to proceed with the expansion of NAFTA. Prior to his election as president of the United States, Bill Clinton endorsed the idea of extending the agreement: "If we can make this agreement work with Canada and Mexico, then we can reach down into the other market-oriented economies of Central and South America to expand even further."

Several questions remain to be answered: How and when should NAFTA be expanded? Which countries would negotiate first? What if some of the governments agree to the conditions and then fail to implement them, as has occurred in virtually all the subregional trade agreements? An even more interesting question is whether Mexico might have been trying to make itself into a "hub" rather than a "spoke" by reaching agreements with other Latin American governments.[29] Will Venezuela, Chile, or Central America, for example, be able to use Mexico as a springboard to export goods duty-free to the United States? Will Mexico in effect define the rules for the entry of these other countries?

These questions have generated answers across the political and policy spectra, but the answers that count will have to be defined by all three governments under the auspices of the North America Trade Commission. Rather than try to speculate which of these various scenarios is the more likely, this paper will assess alternative answers to each question.

When Should NAFTA be Expanded?

Given the complexity of the agreement and the prospect that there will be many new problems, some anticipated and others not, it would be wise to allow an interim of at least two years before beginning serious negotiations to expand it to the rest of the hemisphere. In the meantime, countries should be encouraged to implement unilaterally the conditions and obligations of NAFTA; that would expedite the negotiations once they start.

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28. U.S. Agency for International Development, *Latin America and the Caribbean: Selected Economic and Social Data* (Washington, D.C., April 1992), pp. 3-5.

29. Ronald Wonnacott first developed the "hub" and "spoke" ideas with the United States as the object. See his "U.S. Hub-and-Spoke Bilaterals and the Multilateral Trading System," Commentary (October 1990), Toronto: C.D. Howe Institute.

One of the reasons that Mexico's privatization campaign was so successful was the meticulous preparation before each sale. Making NAFTA work will not be as simple as signing the treaty; it will require experimenting with new institutions and new procedures, and (probably) numerous mistakes. Unless problems are identified and resolved satisfactorily in the first years, the wider experiment could be endangered.

Who Comes First?

President Bush promised Chile's President Patricio Aylwin that the United States would negotiate with Chile as soon as NAFTA was ratified. Chile's economy is the most open, its trade with the United States relatively small, and its technocrats among the most able. If the United States decides to let other governments set its agenda, or if it chooses the agreements that would be easiest to negotiate, then Chile should come first, particularly because Chile already has a free-trade agreement with Mexico. But there are alternative approaches.

Beyond Canada and Mexico, the countries with the closest economic relationships with the United States are those of the Caribbean and Central America—the Caribbean Basin countries. The dependency of these countries on the U.S. market is roughly comparable to that of Mexico and Canada; about 60 percent-75 percent of their trade and investment are with the United States. When President Reagan proposed the Caribbean Basin Initiative—one-way free trade on certain products from the region—in February 1982, he advertised it as a way to promote the region's development.

The motive of the United States motive was strategic—to counter leftist influence in the region—but the program was implemented at a time when the economies of the region were suffering severe dislocations. One of the principal reasons was the sharp contraction of U.S. sugar import quotas. Between 1975 and 1981, the region exported an average of 1.7 million tons of sugar per year to the U.S. That was reduced to 442,200 tons by 1989, with further reductions in the next two years. From 1982 to 1989 alone, the region lost about $1.8 billion in potential revenue and 400,000 jobs as a result of sugar quotas. In comparison, CBI created about 136,000 jobs in manufacturing between 1983 and 1989.[30]

Since many countries in the region were dependent on the sugar industry, and since all of them had small, open economies, the adjustment was severe. CBI helped to cushion the shock, but NAFTA will virtually eliminate the CBI incentive to invest. The region faces a very difficult choice: whether to lower their own barriers to trade and investment and negotiate entry into NAFTA, or hope that the marginal difference in market access between CBI and NAFTA will be small enough not to divert current and future investments from the region to Mexico.[31] The Caribbean might be lulled into avoiding this

30. Joseph Pelzman and Gregory K. Schoepfle, cited in "U.S. Sugar Quotas and the Caribbean Basin," by Stuart Tucker and Maiko Chambers, Overseas Development Council, Policy Focus No. 6, December 1989, p. 4; "Yet Another Cut in the U.S. Sugar Quota," *Latin America Weekly Report,* 10 September 1992, p. 8.

31. For two papers describing the full range of choices that the region faces, see Camille Nicola Isaacs, "The North American Free Trade Agreement: A Jamaican Perspective," paper presented at a seminar at the Mona Institute of Business of the University of the West Indies, 11 December 1991; and Robert Pastor and Richard Fletcher, "The Caribbean in the Twenty-First Century," *Foreign Affairs* 70 (Summer 1991).

hard choice because it has the added advantage of access to the European Community via the Lomé Convention.

The Central American Common Market (CACM) was established in 1960. The thirteen-nation Caribbean Community (CARICOM) was founded in 1973. Both are struggling to find an answer to the question of whether or not to join NAFTA. Both trading areas had been among the most successful in the developing world in the 1960s and 1970s,[32] but the CACM fell victim to the civil wars in Central America, and CARICOM repeatedly failed to implement its goals, most notably a common external tariff (CET).

The issue for the United States—and Mexico and Canada—is whether to find a transitional mechanism or delayed procedure that would permit the Caribbean Basin countries to dock on to NAFTA. From a strategic and political perspective, it would be desirable for the Caribbean Basin countries *as a group* to be the first to join an expanded NAFTA, but the North American countries would not want to allow such a broad exception to NAFTA for fear that it would function as a disincentive for Mexico to implement the agreement or for the rest of Latin America to try to fulfill its obligations.

Jamaica's Ambassador Richard Bernal offered a thoughtful proposal in suggesting that the Caribbean Basin countries be granted parity with Mexico as a way to preserve their CBI benefits and that they would then phase in their reciprocal obligations over a long transition period.[33] Because of its small population, the region is not really competitive to Mexico, but the first decision on whether the proposal makes sense should be made by Mexico.

Beyond the Caribbean Basin, NAFTA should negotiate with whichever subregional group—either the Andean Pact or MERCOSUR—is ready to take advantage of the agreement and has progressed sufficiently in terms of economic reforms to ensure a smooth negotiation. In general, however, the United States, Mexico, and Canada ought to encourage nations to join a western hemisphere economic area as part of a group rather than as individual governments.

How to Deal with Violations of the Agreement?

GATT's failure to answer this question effectively threatens the institution's existence. The standard procedure for handling violations in the GATT is for individual governments to petition the GATT to investigate an alleged violation, and if one is established, to allow governments to seek compensation or to respond proportionately in another area. NAFTA has a similar dispute-settlement mechanism, but there are reasons to question whether it will work any better. The United States has more economic leverage to gain compensation for an alleged trade violation from Mexico and Canada than these two countries have on the United States, but such leverage does not always produce changes

32. See U.S. Department of State, Bureau of Intelligence and Research, *Evaluating Regional Schemes for the Promotion of Inter-LDC Trade: A Review of Selected Attempts to Create Free-Trade Areas and Common Markets,* Report No. 1362, April 14, 1980.

33. Dr. Richard Bernal, "Impact of NAFTA on the Economic Development of the Caribbean and U.S.-Caribbean Trade," statement made at the Hearing before the House Committee on Small Business, December 16, 1992.

in policy. A much tighter mechanism with clearer rules of procedure is necessary, and the nonparties to the agreement have to support the aggrieved complainant to make the system work.

Will Mexico be a Hub or a Spoke?

No one would have posed this question at the beginning of the NAFTA negotiations. The only question then was whether the United States would be the hub or accept a different kind of relationship with the other members. NAFTA is a genuinely trilateral agreement despite the asymmetry in trade. What was not anticipated was the extent to which Mexico has preempted NAFTA by reaching out to its Latin American and Caribbean neighbors. One of Salinas's reasons has been political; he is eager to show Mexican critics that he has not aligned himself solely with the United States and abandoned his Latin American neighbors. Another reason for Mexico's new trade initiatives in the hemisphere is that Mexico's trade in the area is so small, but the multiplicity of agreements does raise the question whether Mexico could become a hub for Latin America or even a platform for their exports.

NAFTA's rules-of-origin provisions were negotiated to prevent Mexico from being any other country's platform, even though the greatest fear was that Japan, not Latin America, would use it for that purpose. If violations are detected, then a common NAFTA institution—perhaps the Trade Commission—would need to impose heavy fines. But it is possible that a freer trade relationship between Mexico and Latin America could facilitate the latter's entry into an expanded NAFTA.

Potential Consequences of NAFTA

The most positive potential impact of NAFTA in the Western Hemisphere lies in its triple incentives for Latin American governments to (1) consolidate needed economic reforms, (2) stimulate subregional integration, and (3) forge a democratic community of nations. Each of these goals is vital to the economic and political development of the region, but before NAFTA, the conditions did not exist and the incentives were too weak to transform those goals into reality. A salutary effect of the debt crisis is that it forced Latin America to reassess its economic strategy. A new generation of Latin American leaders realized that while Latin America had declined, the Asian economies—particularly the "Four Tigers"—had leaped ahead of them by using export-oriented economic policies. The lesson they learned was that they should replace their protectionist strategies with international ones. The IMF, of course, "encouraged" a shift in this direction.

By 1992, there were signs that the new economic policies were bearing fruit. The debt crisis apparently peaked several years before, and governments were able to channel their scarce resources toward investment. As a percentage of GDP, debt declined from 64.3 percent in 1987 to 37.4 percent in 1991. Hyperinflation was brought under control. The average rise in prices for the region, weighted by GNP, fell from 1,711 percent in 1990 to 223 percent in 1991. In 1991, the region grew by 3 percent, the first real growth in many years. Exports expanded at an annual rate of 12 percent from 1987 to 1991, and the percentage of manufactures rose to one third, up from 10 percent two decades ago.[34]

34. U.S. Agency for International Development, *Latin America and the Caribbean: Selected Economic and Social Data* (Washington, D.C., April 1992), pp. 3-4; United Nations Economic Commission for Latin America and the Caribbean, *Preliminary Overview of the Economy of Latin America and the Caribbean, 1991* (Santiago, December

Latin America seemed to turn a corner economically, but social problems were worse than a decade before. Real minimum wages in 1991 were almost a third lower than in 1980. This meant that the average labor cost in Latin America had declined to less than half of what it was in Singapore and Hong Kong,[35] but there were questions as to whether the economic policies could be sustained in a climate of social unrest, such as occurred in Venezuela in early 1992. A Western Hemisphere Free Trade Area could reinforce efforts by each country to maintain the best macroeconomic policies and, as such, it could play a valuable role in helping to modernize the economies.

NAFTA also makes more attainable the goal of subregional integration. For too long, the nations of the Andean Pact, CARICOM, and CACM were unwilling to make the kinds of decisions that would have fulfilled their pledges to lower trade barriers among members of their group. In the case of CARICOM, the failure of any of the 13 members to implement the common external tariff paralyzed the entire organization. NAFTA—and more precisely the prospect of a guaranteed market in North America—provides a substantial incentive for the governments to take action or risk being left out of the growing regional market.

While the United States has encouraged Latin American governments to apply for free-trade agreements as members of subregional integration schemes, there are no incentives to do so, and because of the difficulty of gaining the approval of others, the real incentives favor individual applications. Theoretically, a Western Hemisphere economic area would make subregional integration schemes obsolete, but for the next ten years (at least) the schemes will exist, and it would be desirable for members of each to help the others satisfy the preconditions for entry. Therefore, the NAFTA countries should indicate that individual governments will be permitted to join NAFTA but that subregional groups will take precedence.

Finally, research by Inglehart and others indicates that increasing economic integration within a framework that builds trust between partners can lead to political cooperation and subsequently political integration. The process of negotiating an expansion of NAFTA could stimulate more cooperation on political issues. For example, the leaders in most of the new democracies in Latin America are aware of the fragility of their regimes and are interested in developing mechanisms to defend democracy in all of their countries. The Organization of American States has been wrestling with this issue since it was asked to observe the elections in Nicaragua, but especially since the General Assembly passed a resolution on democracy at Santiago in June 1991. Much remains to be done, and increased cooperation among like-minded leaders on economic matters could translate into new political arrangements to defend democracy. Moreover, the United States and Latin America can work together in GATT to stimulate needed reforms in the international trading system.

With an infrastructure and a potential market roughly equivalent to Europe at the beginning of the Marshall Plan, Latin America today could be the basis for a new and powerful economic community of democratic nations. Together with the United States, the Americas could develop a global competitive economic edge.

35. The statistics are from a report by the International Labour Office, cited in "More Work, But Much Less Real Pay," *Latin American Weekly Report,* 4 June 1992, p. 8.

When Salinas said that "we want Mexico to be part of the First World, not the Third,"[36] not only was he encouraging the people of Mexico to raise their hopes and standards, but he was also affirming that Mexico could exert greater influence on the international economic order if it were aligned with the United States than if it joined the developing world. This represents a momentous departure for Mexico and all of Latin America. After having resisted integration with the United States for decades, the region has apparently concluded that their economic goals are more likely to be attained in cooperation with the north.

Comparative Advantage and the Three Panregions

Consider the three panregions: the European Community, Japan and East Asia, and the North American Free Trade Area as the center of a Western Hemisphere Free Trade Area (Table 4). The most integrated of the three areas is the 12-nation European Community, with a population of 345 million and a gross product of $5.9 trillion in 1990. By December 31, 1992, the EC theoretically eliminated all of its internal barriers. With the Treaty of Maastricht, signed in December 1991, the twelve governments committed themselves to moving toward a federal government that included a unified currency by the end of the century and a coordinated and unified foreign and defense policy. This leap forward was rejected by the Danes and sharply questioned by the British. In all likelihood, the steps toward further unity will not be in a straight line.

While the EC has been trying to deepen and unify its internal market, it has had to cope with numerous other issues and problems. It has had to rework its relationship with its former colonies, the ACP (African, Caribbean, and Pacific) countries. Germany has concentrated its resources on integrating the former East Germany. Austria, Sweden, and Finland have requested membership into the EC; the European Free Trade Association (EFTA) has agreed to join with the EC to form a single unified free trade area on January 1, 1993; and virtually every old and new nation in Eastern Europe has requested some form of association with the EC. The global implications of these developments is that the EC has been inward-looking.

Japan has become the economic center of an increasingly dynamic Asia, but aside from ASEAN, a trade group of five southeast Asian nations, there is as yet no formal trade regime that could compare to that of the European Community, and the region is much less integrated than either Europe or North America. In 1990 and 1991, for example, intraregional trade as a percentage of its total world trade was roughly 62 percent for Europe, 42 percent for North America, and 30 percent for Asia (Table 5).

Most Asian nations are increasingly dependent on Japanese investment and the U.S. market. Lawrence Krause proposes a "Pacific Basin" community that would include Japan, the United States, and 13 other countries. The region's real trade growth in the 1980s was 8.7 percent—higher than the EC's 6 percent—and it was more integrated, with intraregional trade of 65.7 percent compared to 58.6 percent for the EC.[37]

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36. Carlos Salinas de Gortari, "State of the Nation Address, November 1, 1990." FBIS, 14 November 1990, p. 13.

37. Krause, "Regionalism in World Trade," *Harvard International Review,* Summer 1991, p. 5.

Table 4

The World's Three Main Trading Areas: Basic Indicators

Region/Country	Population (Millions) 1970	1990	GNP ($Bil - Current) 1970	1990	GNP per Capita * (US$ - Current) 1970	1990	Exports Customs Basis, fob ($Mil - Current) 1970	1990	Imports Customs Basis, cif ($Mil - Current) 1970	1990
Western Hemisphere	*499.27*	*705.48*	*1,343.78*	*6,907.10*	*821.44*	*3,285.00*	*74,876*	*619,936*	*70,356*	*730,988*
North America	278.59	362.70	1,225.96	6,204.60	3,339.27	14,916.67	60,610	523,236	56,664	659,580
United States	205.00	250.00	1,105.50	5,447.50	5,392.68	21,790.00	43,220	371,466	39,950	515,635
Canada	21.32	26.50	83.58	542.46	3,919.57	20,470.00	16,185	125,056	14,253	115,882
Mexico	52.27	86.20	36.88	214.64	705.57	2,490.00	1,205	26,714	2,461	28,063
Caribbean Basin	30.55	48.28	11.80	53.63	573.38	2,366.19	2,873	10,970	4,088	17,559
Central America	16.89	28.78	6.48	30.21	424.29	1,264.29	1,231	4,929	1,623	8,350
Caribbean	13.66	19.50	5.32	23.42	647.93	2,917.14	1,642	6,041	2,465	9,209
South America	190.13	294.50	106.02	648.87	587.00	1,725.00	11,393	85,730	9,604	53,849
Andean Pact	55.53	91.20	30.02	130.93	524.00	1,318.00	5,349	30,900	3,766	17,762
Mercosur	125.10	190.10	68.02	492.33	602.50	2,180.00	4,810	46,251	4,858	29,064
Chile	9.50	13.20	7.98	25.61	840.00	1,940.00	1,234	8,579	980	7,023
European Community										
EC (1970)	*188.32*		*495.98*		*3,231.53*		*88,545*		*88,425*	
EC (1990)		*344.39*		*5,878.78*		*15,380.88*		*1,349,971*		*1,405,273*
Asia	*346.16*	*512.32*	*242.12*	*3,772.56*	*444.90*	*7,742.22*	*31,812*	*641,969*	*35,819*	*674,477*
Japan	104.00	123.50	203.30	3,140.61	1,954.81	25,430.00	19,320	286,768	18,880	231,223
ASEAN	204.21	316.77	29.88	300.71	353.83	3,240.00	6,161	140,537	7,696	160,369
Four Tigers	37.95	72.05	8.94	331.24	280.10	9,350.00	6,331	214,664	9,243	282,885

Key: Andean Pact : Peru, Colombia, Ecuador, Venezuela, Bolivia
EC (1970): Belgium, France, Germany, Italy, Luxembourg, Netherlands
ASEAN: Brunei, Malaysia, Singapore, Indonesia, Phillipines, Thailand
Four Tigers: Hong Kong, Singapore, South Korea, Taiwan
Mercosur: Brazil, Argentina, Uruguay, Paraguay
EC (1990): Belgium, France, Germany, Italy, Luxembourg, Netherlands, Denmark, Greece, Ireland, Portugal, Spain, United Kingdom

Notes: German 1990 population data after unification; German trade & GNP data are prior to unification; trade data for Belgium includes Luxembourg; and (*) Regional GNP per Capita are averages.

Sources: The World Bank, "World Tables," 1984, 1991; and "World Development Report," 1992; and U.S. Agency for International Development, "Latin American and Caribbean: Selected Economic and Social Data," April 1992; and OECD "Monthly Statistics on Foreign Trade," July 1992.

Table 5
Intraregional Trade as a Percentage of Total Trade

	Exports *Customs basis, fob*					**Imports** *Customs basis, cif*				
	1970	**1976**	**1980**	**1990**	**1991**	**1970**	**1976**	**1980**	**1990**	**1991**
North America	37.34	37.82	36.09	42.91	41.98	40.61	34.15	32.52	35.54	36.47
European Community	n.a.	52.25	53.53	60.58	61.89	n.a.	49.37	48.31	57.92	57.61
Asia	n.a.	36.24	17.92	30.61	30.03	n.a.	39.07	18.93	36.67	36.44

Note: 1991 intraregional trade data for Asia are based on IMF and World Bank estimates.

Sources: OECD "Monthly Statistics on Foreign Trade," July 1992; "Historical Statistics on Foreign Trade, 1965-1980," 1982; and International Monetary Fund, "DIrection of Trade Statistics," 1984, 1991, 1992.

Some have argued that the United States would be making a mistake to create a trade bloc in the Western Hemisphere among slow-growth economies. The Asian economies, according to this view, offer the best vehicle for invigorating the U.S. economy. "There's much more to gain by fighting for access to China, South Korea, Taiwan, Japan and the European Community than by signing free-trade agreements across Latin America," wrote Marc Levinson in *Newsweek*.[38] The idea of looking east rather than south merits consideration, but the Pacific Basin is not a realistic trade entity in the short term because of the tremendous differences between the United States and Japan on trade policies and the continued difficulty that the United States and Latin America face in penetrating the Japanese and Asian markets.

The North America trading area is competitive. For Canada and Mexico, which have more than two thirds of their trade with the United States, it is central. But even for the world's greatest trading power, the United States, which has often focused on Europe or Japan, its two neighbors have been its largest markets in the postwar period. In 1955, two years before the signing of the Treaty of Rome, U.S. exports to Europe were $2.6 billion, compared to $4 billion of exports to Canada and Mexico (Table 6). Thirty-five years later, U.S. exports to Asia had increased from 10 percent to 15 percent of U.S. exports, and to Europe, from 16.8 percent to 25 percent. But North America remained preeminent: U.S. exports grew to $112 billion or 28.4 percent.

Table 6

U.S. Exports to North America, Europe and Asia (1945-1991)
($Mil)

Year	North America	EC	Japan & SE Asia	World
1945	1,485	3,114	1,381	10,527
1955	3,969	2,614	2,144	15,518
1965	6,763	5,252	5,180	28,461
1975	26,885	22,865	19,658	109,317
1980	55,476	58,855	44,512	225,722
1985	66,922	45,776	51,036	213,146
1986	67,904	53,222	52,981	227,159
1987	74,396	60,629	58,244	254,122
1988	92,250	75,864	88,841	322,426
1989	103,791	86,424	101,509	363,812
1990	111,953	98,129	109,054	393,592
1991	118,379	103,209	109,674	421,614

Sources: USDOC, International Trade Administration, "U.S. Foreign Trade Highlights," 1992, 1988, 1985; and USDOC, Office of Business Economics, "U.S. Exports & Imports 1923-1968,: November 1970; and USDOC, Bureau of Economic Analysis, "U.S. Merchandise Trade: Exports & Imports 1965-76," 1977; and USDOC, Bureau of the Census, "Statistical Abstract of the United States," various issues, 1950-1991.

38. Both Bhagwati and Krause make this argument. For a more popular and acerbic statement of this thesis, see Marc Levinson, "Let's Have No More Free-Trade Deals, Please: Why NAFTA is not a Model for Latin America," *Newsweek,* August 17, 1992, p. 40.

An analysis of U.S. exports to North America, Europe, and Asia in the post-war period underscores the degree to which the United States remains the center—both in geography and in terms of the value of trade—of the world trading system. It also shows the extent to which world trade is dominated by three regions. The least integrated region—Japan and Southeast Asia—has shown the fastest growth, particularly in the last two decades. U.S. exports to Japan, ASEAN, and the four "Asian tigers" increased from less than $20 billion in 1975 to $110 billion in 1991. Of those markets, Japan's has accounted for about half, although in the last decade the markets of the rest of Asia increased in relative importance. Nevertheless, North America has consistently remained a larger market for U.S. goods than the European Community or Asia.

The trends are similar for U.S. imports, with North America accounting for one quarter of U.S. imports and Europe for 19 percent. The difference, of course, is the extraordinary growth of Japanese and Asian exports to the U.S., from $1 billion in 1955 to nearly $100 billion in 1990, nearly 20 percent of total U.S. imports.

Canada has always been the principal U.S. trading partner, and the growth of this trade has remained relatively consistent. The highest rate of growth of U.S. exports has occurred with Mexico. With NAFTA secure, that is likely to expand even further.

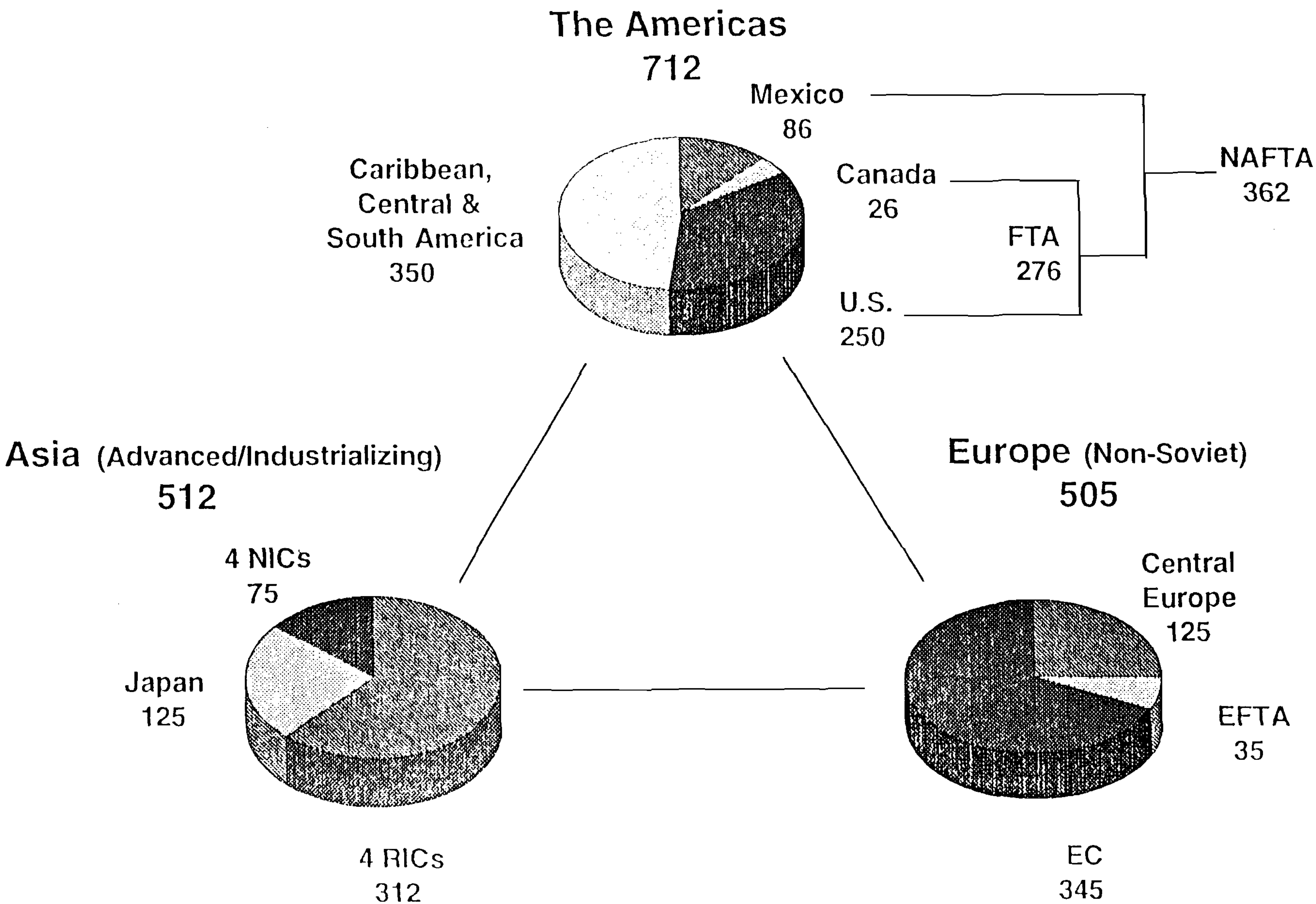
Although the South American market has declined in importance for the United States in recent years, if added to North America, the new hemispheric market assumes much greater weight for the United States (Table 7). U.S. exports to the entire hemisphere are about one third greater than to Europe or Asia. Moreover, an expansion of NAFTA to include the Caribbean Basin and South America would effectively double the population (Figure 1) with a gross product that greatly exceeds Europe's or Asia's and additional advantages the others do not enjoy.

Table 7
U.S. Exports to North and South America, Europe and Asia (1945-1991)
($Mil)

Year	North & South America	EC	Japan & SE Asia	World
1945	2,438	3,114	1,381	10,527
1955	6,327	2,614	2,144	15,518
1965	10,196	5,252	5,180	28,461
1975	39,265	22,865	19,658	109,317
1980	79,076	58,855	44,512	225,722
1985	84,143	45,776	51,036	213,146
1986	86,449	53,222	52,981	227,159
1987	94,617	60,629	58,244	254,122
1988	115,334	75,864	88,841	322,426
1989	127,454	86,424	101,509	363,812
1990	137,082	98,129	109,054	393,592
1991	144,967	103,209	109,674	421,614

***Sources:** USDOC, International Trade Administration, "U.S. Foreign Trade Highlights," 1992, 1988, 1985; and USDOC, Office of Business Economics, "U.S. Exports & Imports 1923-1968," November 1970; and USDOC, Bureau of Economic Analysis, "U.S. Merchandise Trade: Exports & Imports -1965-1976," 1977; and USDOC, Bureau of the Census, "Statistical Abstract of the United States," various issues, 1950-1991.*

Figure 1
The Three Panregions
1990 Population (millions)



The effort by Western Europe to incorporate the east has confronted more serious problems than Latin America's economic integration presents to the United States and Canada. While Latin America is privatizing its relatively few state corporations, Eastern Europe is trying to decide how to introduce the market into state-controlled economies. After almost a decade of depression, Latin America is in many ways at the stage where Western Europe was after World War II. It has considerable unused industrial capacity, a highly trained labor force, and a proven capacity to grow. All it needs is capital (or reduced debt service) and a secure market. The sharp reduction of trade barriers in the Western Hemisphere could provide the stimulus toward an economic take-off comparable to what occurred in the 1960s and early 1970s.

In analyzing the implications of NAFTA for the other two regional trading areas, it is useful to recall that all three areas have significant interests in world trade and in maintaining the GATT. This does not mean that they have an equal interest. The United States is the largest exporter and importer of goods in the world, but Germany and Japan are much more dependent on world trade than the United States. More important, Japan and, to a lesser degree, Germany, are more dependent on the U.S. market than the United States is on them (Table 8). Japan's exports to the United States represent roughly one third of its total exports and about 3 percent of its GDP. In contrast, U.S. exports to Japan amount to about 11 percent of its exports and less than 1 percent of GDP. Obviously, Japan has much greater reason to be concerned that NAFTA could lead to a closing of the North American market than the United States has to be worried about Japan's market. Even though Germany is more dependent on the United States than the United States is on Germany, the gap is much narrower, and that is yet another reason why the European Community is less worried about NAFTA than it is about making the EC work, and why Europe is less worried than Japan.

The global configuration means that NAFTA is likely to attract the attention of Japan and to a lesser degree Europe. How they react is another matter. Their initial reaction may be negative and fearful, but as they realize the importance of their stake in the U.S. market, they will concentrate more and more on making the GATT work. That will mean, among other things, adopting some of NAFTA's innovations—for example, on dispute settlement, services, and perhaps agriculture—and trying to incorporate them into an invigorated GATT.

It is obvious why Latin America would want greater and more secure access to the U.S. market. A question has been raised as to the reason why the United States would want to consider extending NAFTA to the rest of Latin America. There are several reasons. First, the United States would gain access to a market that is much more protected than the U.S. market. Second, if trade could help stabilize and develop Latin America's economies and reinforce its budding democracies, such a wider market would serve broader U.S. strategic and political interests. Third, South America has enormous resources and potential. If these were developed, then the hemisphere would become a bloc with considerable weight and leverage in the international community.

Table 8: Trade Dependency of the Three World Powers

United States	GDP @ mkt prices ($Mil)	Total Exports (fob) ($Mil)	Exports to Japan ($Mil)	% Total U.S. Exports (%)	Exports to Japan as % of US GDP (%)	Exports to Germany ($Mil)	% Total U.S. Exports (%)	Exports to Germany as % of US GDP (%)
1960	509,000	20,600	1,341	6.51%	0.26%	1,068	5.18%	0.21%
1970	1,008,200	43,762	4,652	10.63%	0.46%	2,741	6.26%	0.27%
1980	2,684,400	225,722	20,790	9.21%	0.77%	10,960	4.86%	0.41%
1990	5,392,200	393,592	48,580	12.34%	0.90%	18,760	4.77%	0.35%
1991	5,672,600	421,600	48,147	11.42%	0.85%	21,317	5.06%	0.38%

Japan	GDP @ mkt prices ($Mil)	Total Exports (fob) ($Mil)	Exports to US ($Mil)	% Total Jap Exports (%)	Exports to US as % of Jap GDP (%)	Exports to Germany ($Mil)	% Total Jap Exports (%)	Exports to Germany as % of Jap GDP (%)
1960	50,095	4,709	1,149	24.40%	2.29%	372	7.90%	0.74%
1970	143,511	19,405	5,875	30.28%	4.09%	1,528	7.88%	1.07%
1980	1,840,335	130,441	30,867	23.66%	1.68%	5,786	4.44%	0.31%
1990	2,942,890	287,581	89,684	31.19%	3.05%	17,894	6.22%	0.61%
1991	3,642,975	338,329	91,583	27.07%	2.51%	20,631	6.10%	0.57%

Germany	GDP @ mkt prices ($Mil)	Total Exports (fob) ($Mil)	Exports to US ($Mil)	% Total Ger Exports (%)	Exports to US as % of Ger GDP (%)	Exports to Japan ($Mil)	% Total Ger Exports (%)	Exports to Japan as % of Ger GDP (%)
1960	84,481	15,394	897	5.83%	1.06%	88	0.57%	0.10%
1970	136,352	35,329	3,127	8.85%	2.29%	146	0.41%	0.11%
1980	775,667	192,861	11,924	6.18%	1.54%	2,186	1.13%	0.28%
1990	1,488,210	410,104	28,162	6.87%	1.89%	10,816	2.64%	0.73%
1991	1,728,152	439,135	26,229	5.97%	1.52%	10,745	2.45%	0.62%

Sources: World Bank, "World Development Report," 1992; and International Monetary Fund, "Direction of Trade Statistics," 1976-1982, 1991, 1992 and World Bank, "World Bank Tables," 1976, 1988, 1991; and U.S. Department of Commerce, International Trade Administration, "U.S. Foreign Trade Highlights," 1992; and "Statistical Abstract of the United States," U.S. Department of Commerce, Bureau of the Census, various issues, 1950-1991; OECD, "Main Economic Indicators," July 1992.

Some Proposals

The NAFTA debate within the United States will be difficult and awkward. The United States is perched on the fence between risking openness and opting for an elusive defensiveness, the same kind of choice that Mexico faced. It is ironic that the United States and Mexico have reversed roles. If U.S. legislators are arrogant and insensitive during the debate, the process of integration will be set back, but that process—whether private or managed—will continue as long as each country perceives that the gains from trade exceed the cost.

Cost-benefit calculations have objective and a subjective dimensions: whether the gains exceed the costs, and whether the public perceives that the gains exceed the costs. The U.S.-Canadian agreement offers an example of a case where economists concluded that Canada gained, but only 6 percent of the Canadian public agreed. The opposition to the FTA—66 percent—blame the agreement for the recession and for generating numerous trade disputes, most of which seem to be resolved in favor of the United States.[39] As a result, both NAFTA and the Mulroney administration are unpopular.

There are important lessons in the U.S.-Canadian experience, but NAFTA shows no signs that they have been learned. Like other trade agreements, NAFTA will generate more trade problems, not fewer, because businesses and workers will become more dependent on the success or failure of trade flows, and they are more likely to complain if they fail than to credit the agreement if they succeed. Moreover, the agenda of legitimate issues will expand because of the nature of the nontariff issue and the logic of economic integration: all policies that could help a country's exports or hurt a country's imports are on the table.

The following tasks need to be accomplished to sustain, deepen, and extend NAFTA:

(1) collect data and information on trade and investment policies;
(2) establish a credible and effective body to judge disputes and to enforce judgments;
(3) establish a separate inter-American body to consult, negotiate, and plan for future problems;
(4) establish an inter-American body made up of democratically elected representatives, comparable to the European Parliament, to address and debate issues and concerns; and
(5) establish an office to disseminate information on the activities, accomplishments, and mistakes of the inter-American bodies.

Information Collection

The Special Committee for Consultation and Negotiation (CECON) of the Organization of American States was established in 1970 to collect information on trade and trade policies in the hemisphere and publish some of the information in a newsletter. In May 1992, CECON was renamed the OAS Special Committee for Trade and given some new missions, among them to be a vehicle for consultation on trade issues among the member governments and to promote trade liberalization and

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39. See the following two articles by Clyde H. Farnsworth in *New York Times,* "U.S.-Canada Rifts Grow Over Trade: Accusations on Beer, Cars, and Lumber," February 18, 1992, pp. 1, C6; and "U.S. Trade Pact a Spur to Canada," July 22, 1992, pp. C1, C6.

expansion. Member governments were concerned that CECON was too confrontational, even though a more telling and accurate criticism is that it has been too anodyne.

To make a Western Hemisphere Free Trade Area workable, a new institution is needed to collect information on trade and investment policies and provide credible, impartial, and effective judgments on what qualifies as "protectionist." A single standard needs to be developed and applied. An annual report on protectionism—defined either as violations of existing trade agreements or government-directed reductions in trade and investment—would be a valuable document on which everyone could depend. But the information has to stand the test of public criticism, and it has to be disseminated widely.

It is important not to underestimate the importance of having a base of information that all view as fair. Public opinion polls show that the American public supports freer trade, provided our trading partners play by the same rules. As there is a growing feeling in the United States that our trading partners are playing by different rules that are not fair, the consensus for freer trade has begun to fragment. One way to reconstruct that consensus is to have credible, fair information available to all parties. This will not eliminate political problems or trade disputes, but it will lessen them.

An important question is where to locate the data-collection system. CECON could do the task of data collection, but it might not be prepared to make the controversial judgments necessary to identify the source of emerging trade problems. The United Nations Economic Commission for Latin America and the Caribbean has the capability and experience, and the Inter-American Development Bank could manage such a group as well. To the extent that the group's judgments would be controversial, it will be better for the institution to have a clearly defined autonomy and be composed of senior statecrafters and judges from throughout the Americas.

Dispute Settlement Mechanisms

The trade dispute settlement mechanisms in NAFTA are quite complicated and emphasize consensus. The central institution created by NAFTA is the Trade Commission composed of cabinet-level officers of each country. The daily work is to be done by a Secretariat. If normal consultations fail to resolve a problem within 45 days, any country can call a meeting of the Trade Commission, which should settle the dispute promptly. If it fails, then a country can call for an Abritral Panel, either under NAFTA or GATT, which will issue a report within three months with recommendations for resolving the problem. If the parties do not accept the recommendation, then the complaining country can suspend the application of equivalent benefits until the issue is resolved. Any country that considers the retaliation excessive may seek another panel's recommendation.

The central flaw of the mechanism is the absence of collective enforcement, and that is because all three governments apparently prefer weak or nonexistent institutions to ones that they could not control, or that could intrude on "sovereignty." But a weak institution would undermine NAFTA. Problems in interpretation and enforcement are inevitable, and all three governments would benefit from the enforcement of trade violations, just as all would be harmed by the lack of enforcement. The United States is strong enough to accommodate virtually any decision, and Canada and Mexico need the institution to ensure that their interests would not be ignored or overridden unfairly. To a substantial degree, the GATT's weakness stems from its inability to enforce its decisions. A similar flaw in NAFTA could doom the institution even before it was firmly established.

Consultation, Negotiation, and Planning

NAFTA's Trade Commission is intended to serve as a body for consultation, but it is unclear whether it will serve a similar negotiating function, and no body is charged with considering the steps required to move from NAFTA to a Western Hemisphere Trade Agreement. Moreover, it appears that the mandate of the Trade Commission—as illustrated by its very title—is too narrow to take into account the full range of problems of integration and interdependence. Perhaps the Trade Commission could appoint a Planning Group composed of representatives of the three countries and of others in Latin America to begin to outline the steps needed and their timing to make the transition to a wider trading area.

Parliament of the Americas

While it is too soon to establish a parliament of representatives of the states of the Americas, it is not too soon to begin to think about the idea. If the premise is accurate—that a Western Hemisphere economic area will mean that domestic agendas will become the subject of international negotiation—then a forum will be needed to debate norms and policies on such issues. The prospect for success of the United Nations Environmental Conference in the summer of 1992 would have been far higher if the nations of the hemisphere had an opportunity to forge a consensus ahead of time.

What is needed on these domestic-global issues is a discussion among people who can integrate domestic and international interests, and the best forum for accomplishing that would be an international parliament of representatives from each of the countries. Modeled on the European Parliament, seats should be allocated to states according to the size of their population. The planning group should assign long-term issues to the parliament for debate and eventually for resolution.

An Office of Dissemination

Too often, governments have information offices that fail to disseminate reports to people and groups interested in learning about them. Too often, the reports are self-serving. To build a long-term relationship among the countries of the Americas based on freer trade will require a wider understanding of the activities of the various institutions working on the issues. For reports to be effective, they need to describe not only the institution's accomplishments, but also its mistakes and problems, and the information should be disseminated widely.

To accomplish these five tasks will require new ideas, attitudes, procedures, and institutions. None are currently contemplated, but all are needed if the nations of the Americas are serious about wanting to extend NAFTA to the rest of the hemisphere. Consulting and negotiating the full range of issues will equip the region's leaders to begin thinking about new modes of political cooperation, both to defend democracy in the hemisphere and to shape global institutions to take into account the needs of the Americas.

The world has been long divided into trading blocs and, since the Second World War, trading areas. The most highly integrated is the European Community, but Japan's efforts to integrate Southeast Asia also suggest an emerging area in the east. The Western Hemisphere has harbored dreams of a free-trade area for over a century, but the decision to negotiate NAFTA represents the first significant step in that direction. It is a step that will increase trade in North America and could be extended to the entire hemisphere. Beyond that, an expanded NAFTA could serve as a model for a new international trading system. As long as the United States and Latin America continue to recognize their stake in the global trading system, they will be able to utilize their new-found leverage to stimulate GATT to overcome its problems and to generate new trade and growth in the international economy. Together, these steps may add up to a great leap.

II. What Kind of Agreements are Desirable?

CONDITIONS FOR MAXIMIZING THE GAINS FROM A WHFTA

Anne O. Krueger

Until the 1980s, most developing countries followed policies of import-substituting industrialization under which they provided high levels of protection to domestic import-competing industries. In such circumstances, most international negotiations over trading arrangements, and especially trade liberalization, took place among the developed countries.

Through a number of rounds of multilateral trade negotiations (MTNs), the developed countries successively reduced their tariffs to very low levels. Also, by the late 1950s, those developed countries that had quantitative restrictions on imports for balance-of-payments purposes at the end of the Second World War succeeded in eliminating them for nearly all trade. The result was a sustained liberalization of trade among the industrialized countries from the late 1940s to the 1980s.[1] That in turn produced a very rapid rate of growth of world trade, although the failure of many developing countries to eliminate their strong inward orientation meant that the share of world trade accounted for by the trade-liberalizing countries was increasing and the share of developing countries fell. Even so, the developing countries benefitted greatly as bystanders to tariff reduction and trade liberalization among the developed countries.

The General Agreement on Tariffs and Trade (GATT) was founded upon the basic principles of multilateral trade with no discrimination among trading partners. However, in contradiction to this principle, the inward-looking developing countries insisted upon, and received, special and differential (S&D) treatment under GATT. They asked for preferences in the form of lower tariffs contrasted with those on imports from other industrialized countries on their exports to developed countries, and were accorded those preferences under the Generalized System of Preferences (GSP),[2] while simultaneously being exempt from the GATT requirement to reciprocate in multilateral tariff reductions.

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1. To be sure, there were offsets. The most important of these from the vantage point of developing countries' access to markets were increasing protection of agriculture (as European and Japanese agricultural production recovered from the war and pressures once again emerged on small-scale farmers) and quantitative restrictions on textile and clothing imports from developing countries. Until policy changes in the 1980s, there were few developing countries that were even able to fill their quotas under the Multifiber Arrangement (MFA), and exports from developing countries of textiles and clothing grew rapidly [see Cline (1990)]. Hence, these exceptions cannot be said to have changed the trend toward greater trade liberalization by developed countries, at least until the 1980s. By the late 1980s, however, there was concern that the MFA was likely to be increasingly protectionist if the Uruguay Round negotiations failed to produce a signed agreement.

2. It is arguable that, even in the environment of the 1960s and 1970s with the restrictionist trade policies of developing countries, adherence to the open multilateral trading system, with even small additional reductions in developed countries' tariffs, would have provided greater benefit to developing countries. See, for example, Baldwin and Murray (1977); later research has confirmed the Baldwin-Murray findings.

In the 1980s, however, many policy makers in developing countries recognized that restoring sustained and satisfactory growth would not be feasible without a change in trade strategies.[3] In many countries, trade regimes were liberalized; in a few cases, they were even transformed from highly inner-oriented to fairly open economies. As those painful policy changes were undertaken, access to the international market became even more important for future growth prospects.

Just as that happened, however, many observers became skeptical of the ability of the developed countries to maintain open access to their markets. Protectionist pressures emerged and grew stronger in the domestic political arenas of many developed countries, and the Uruguay Round of trade negotiations has dragged on without a final agreement.

Concurrent with those ominous developments, regional trading blocs appear to be emerging. The European Community, although somewhat distracted by events in Eastern Europe and the CIS, is proceeding with its commitment to complete the internal market by the end of 1992. Simultaneously, after the United States and Canada signed a free trade agreement (FTA), Mexico announced its intention to reach an accord on an FTA with the United States, and the United States proposed the Enterprise for the Americas Initiative, which envisages a hemispheric FTA.

The prospect of a Western Hemisphere Free Trade Area (WHFTA) presents both opportunities and dangers for Latin American countries. There is opportunity for improving economic performance and accelerating growth if (a) the WHFTA results in further liberalization of world trade and access to markets for Latin American countries, and (b) appropriate domestic economic policies are in place to permit domestic producers and consumers to avail themselves of the opportunities presented by such an WHFTA. There are dangers if (a) the net result of regional integration arrangements is the emergence of trading blocs that degrade the world trading system, or (b) countries fail to adopt economic policies compatible with liberalized trade.

This paper assesses the possibilities and dangers of a WHFTA and considers the kinds of policies Latin American countries could adopt to provide the maximum scope for gains under a WHFTA. The first section lays out the framework of analysis and indicates ways a country's trade regime affects its economic performance and prospects, the role of domestic economic policies in affecting trade, and the sorts of FTAs that would tend to improve economic performance.

The second section then considers those aspects of an FTA that will be most crucial from the viewpoint of the Latin American countries in shaping future trading arrangements. These range from the symmetry of trading relations to such important but technical issues as rules of origin and dispute-settlement mechanisms.

The third section focuses on domestic economic policies and the ways a country's policies are likely to affect the outcome of an FTA, and a final section summarizes, noting the sorts of trade-offs that Latin American countries may consider in negotiations over an FTA.

3. The reasons for this conclusions are several, and vary somewhat from country to country. Major factors include (1) a harsher world economic environment that is no longer so permissive of slack economic policies; (2) related to that, the shrinkage in the availability of foreign capital; and (3) the belief that import substitution is either a "failed strategy" or one that has already delivered whatever it could toward economic growth.

A Framework for Assessing Alternative FTAs

To analyze the potential of FTAs from a Latin American perspective, the first question to address is the role of trade in facilitating Latin American economic objectives. Then attention turns to ways an FTA might facilitate or impede the contribution of trade to achieving those objectives.

For present purposes, it is assumed that Latin American economic objectives are to achieve higher living standards and real rates of growth of their economies. It is well known that these are but means to ends, and that in fact economic objectives are far more complex. However, most other objectives are functions of domestic economic and other policies, and little affected by trading opportunities. As such, it seems appropriate to analyze the problems and potentials of alternative forms of FTAs according to their impact on economic efficiency and growth.

The Role of Trade in Development

By the late 1980s, there was a consensus that an outer-oriented trade strategy can produce much more rapid and sustained growth than can import substitution. While many questioned the ability of politicians to carry out the transition from import substitution,[4] few doubted that the payoff could be large for a country that successfully makes the transition. Historically, first Korea, Taiwan, Hong Kong, and Singapore, and later Thailand, Turkey, and Malaysia, were sustaining unheard-of rates of growth through an outer-oriented trade strategy and domestic economic policies supportive of that strategy. Meanwhile, countries that had persisted in import-substitution experienced major slowdowns in growth and falling living standards often accompanied by rapid inflation and major difficulties in servicing debt.

To analyze the potential of an FTA, important dimensions to consider include the ways an outer-oriented trade strategy has contributed to economic growth in the successful countries.[5] The answer has to do in part with the shortcomings of import substitution: the small size of the domestic market, the inevitable tendency for heavily protected firms to become high-cost in the absence of sufficient competition, the inability to use comparative advantage, and the consequent necessity to move increasingly into capital-intensive industries with their associated high costs and low incremental output, and the economic consequences of foreign exchange shortages.

But for present purposes, the more important part of the answer has to do with the benefits of an outer-oriented trade strategy. These include phenomena associated both with the competitive stimulus to exports and access of domestic firms to imports from abroad. On the export side, it is evident that the payoff from adopting an outer-oriented trade strategy will be greater, the more open the world

4. For an analysis of the political economy of trade liberalization and other economic policy reforms (many of which are essential if trade liberalization is to have the desired effects), see Bates and Krueger (forthcoming), Nelson (1990), and Michaely, Papageorgiou, and Choksi (1991). The vested interests that build up under import substitution are sure to object to reforms, and political opposition has often led to reversal of reform programs before their benefits could be realized. That the payoff for successful liberalization can be enormous is unquestioned. For a comparison of Korea (which liberalized in 1960 when its per-capita income was less than one third that of Turkey) and Turkey (where import-substitution continued to 1980), see Krueger (1987).

5. The reasons can only be briefly summarized here. For further analysis, see Bhagwati (1988).

economy is to a country's products. In that regard, it is always easier to capture market share in the context of rapid growth than when new entrants must compete with existing suppliers for business. Many consider the rapid expansion in the international economy a major factor at the time Korea and Taiwan were beginning their outer-oriented trade strategies. Once incentives were in place for exporting, domestic firms had little difficulty finding overseas markets.

The benefits of increased efficiency of resource use and economic growth of an outer-oriented trade strategy are also clearly greater when the size of the domestic market is small and a country's resource endowment diverges significantly from the median of the world economy. Small domestic markets generate large benefits from liberalizing trade because of the increased impetus to economic efficiency that arises from competitive forces after liberalization, and firms with small domestic markets are likely to have high fixed costs.[6] It is widely believed that increased competitive pressure is also important in driving down costs, although empirical evidence on this point is sketchy.[7]

On the import side, once trade is liberalized and foreign exchange freely available, firms have access to low-cost sources of supply. This can be cost-reducing both directly and indirectly, and in addition provides an economic way of advancing technical knowledge.[8] It also permits domestic producers to compete with firms in other countries with access to these same low-cost inputs. This is vital if there is to be rapid export growth, not only because it helps keep down exporters' costs directly, but also because it permits better quality control, a necessity for international acceptance of products.

Role of the International Economy in Development

Much of the benefit from shifting to an outer-oriented trade strategy (and the other economic policies necessary to ensure its success) comes from the impact on the domestic economy: increased competition induces firms to reduce their costs and improve quality; domestic pricing of imports to reflect their foreign prices permits a more rational allocation of foreign exchange; and information flows about innovations and improved techniques abroad appear to thrive when trade policies are liberalized.

However, the benefits of trade liberalization increase with greater access to markets in other countries enjoyed by domestic exporters and the more rapid the expansion of the international economy. When there are few barriers to new entrants, those domestic producers who believe they could profitably export are much more likely to take the risks of establishing new markets than when there are trade barriers either in place or likely to be erected if exporters are successful.

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6. In recent years, international trade theory has moved away from reliance on models in which there is perfect competition to models in which markets are imperfectly competitive in the Chamberlain sense of the term. For producing differentiated products where there are given fixed costs and constant marginal costs, it is easily shown that the gains from economic integration include not only a larger variety of products but also a larger volume of production over which to spread fixed cost. See Krugman (1979) for an exposition.

7. See Levinsohn (1991) and Krueger and Tuncer (1982) for two studies generating this result, however.

8. See Grossman and Helpman (1991) for an analysis of the reasons why an open economy may facilitate more rapid growth through mechanisms that rely in some essential way on research and development and innovation.

Likewise, even when there are no barriers to new entrants, newcomers find establishing themselves much less difficult when the overall size of the market is growing and they can increase their sales and market share out of market expansion, than when the overall size of the market is stagnant or growing slowly and they must win customers away from existing suppliers.[9]

Moreover, the extent to which it is profitable to shift resources toward exporting industries will depend on opportunities for exporting; the greater the resource shift toward those lines in which the newly liberalizing countries have comparative advantage, the greater will be the gains that arise from altering policies and shifting to an outer-oriented trade strategy.

The ideal situation for developing countries in the process of trade liberalization would be an open, multilateral world trading system coupled with healthy growth of the world economy. Openness combined with growth would provide the assurance that market access would persist and thus induce domestic producers to respond to incentives for becoming competitive in international markets.

How then can FTAs affect prospects for developing countries? In an ideal world, they would not. All countries would practice free trade.[10] In the current climate, however, FTAs can contribute if they enhance prospects for market access in important markets *and do not undermine the open multilateral trading system.* Put another way, countries whose own economic policies are already highly liberal can gain through FTA arrangements if those FTAs are "GATT-plus" and provide greater assurances that successful exporters will not find protectionist trade barriers erected against them in important markets.

The Costs of Regional Trading Blocs

Suppose that instead of forming a trading arrangement that is GATT-plus, European, Asian, and Western-Hemisphere countries all form regional trading blocs. What would be the likely consequences for the world trading system?

Answering the question precisely is difficult for a variety of reasons. Much of the assessment of potential damage to developing countries depends on how one views the prospects for evolution of the world system once trading blocs have formed. The initial formation of trading blocs would presumably be only the start of increasing trade friction—and trade barriers—between regions. If trade frictions mounted over time, one can imagine two outcomes: either each region would erect increasing barriers against imports from the other, or the costs of this outcome would be seen to be so great that representatives of the countries in the various regions would find ways to reinstitute and strengthen the open, multilateral trading system.

9. In fact, although the rate of growth of economic activity and the height of protection are logically separate, the political economy of protection tells us that trade barriers are related to stagnation. If existing suppliers are domestic firms and new entrants must establish themselves at the expense of those suppliers, the response is often to seek increased trade barriers against imports.

10. To be sure, there would be domestic interventions to correct domestic distortions, and there *might* be infant industries subject to temporary production subsidies. The only case for a border intervention on grounds of national welfare is monopoly power in trade: even then, the likelihood of retaliation reduces the scope for gain through that policy, and in any event, it is world-welfare reducing.

Whether or not the increasing costs of trade barriers prompted renewed interest in strengthening the GATT, the costs to developing countries of the formation of trading blocs that were protectionist vis-a-vis the rest of the world would be of two kinds. The first would be of the trade-diversion type described below, the costs of which increase as the height of trade barriers to countries not in the regional group rises. The second would be the slower growth in demand for exports of any given country because the growth rate of world trade and GNP would inevitably slow down with increasing trade barriers.

During the 1950s and 1960s, the industrialized countries grew at an average annual rate in excess of 4.5 percent, and world trade grew at an average annual rate of 9 percent.[11] During the 1980s, real growth of the industrialized countries slowed to about 2.75 percent, while the growth of world trade slowed to about 5 percent. Although it is a very rough calculation, one might take that difference as indicative of the order of magnitude of difference that trade liberalization makes to world economic growth.

If, therefore, the world were to enter a period of increasing protectionism between regions, one could expect a rate of growth of world trade of less than 5 percent, while if instead the open multilateral trading system and trade liberalization prevails, one might witness the return to 9 percent-10 percent annual growth in the volume of world trade. For developing countries, slow growth of world trade would imply no more rapid growth of exports than 6 percent-7 percent annually,[12] with the most successful countries experiencing growth rates between 10 percent and 15 percent. That contrasts with Korea's and Taiwan's 40-percent annual growth of exports in the 1960s, and Turkey's 25-percent annual growth of exports in the 1980s. By contrast, if world trade and output, spurred by continuing trade liberalization, could resume the growth rates of earlier decades, developing countries as a group could experience 9 percent-10 percent annual growth of exports with little disruption of developed countries' markets.[13] That would permit the high flyers among the developing countries to achieve growth rates similar to those of Korea and Turkey in earlier decades.

Since rapid export growth can contribute significantly to developing countries' growth, one has to conclude that the difference between an average 6 percent to 7 percent growth and an average 9-10 percent growth of world trade could make a difference of at least 2 percentage points on the potential growth rates of developing countries undertaking policy reform and adopting outward-oriented trade strategies.

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11. Intra-European trade grew more rapidly than European trade with the rest of the world. However, European external trade barriers also fell sharply so that European trade with the rest of the world still grew at an above-average rate.

12. Because it is impossible to estimate how protectionist each trade bloc might become if trade frictions mount, it is not possible to quantify the extent to which developing countries' export growth would be restrained. The numbers given here are illustrative of orders of magnitude, and are certainly not "worst-case" scenarios. They nonetheless indicate the vital importance of maintaining an open multilateral world trading system.

13. It is much easier to break into a rapidly growing market than it is to enter a stagnant one. If orders must be gained at the expense of existing producers, protectionist pressures rise sharply in developed countries. If, instead, new markets can be found because incomes are growing, exports can increase substantially and market share increased without causing a decline in production and sales for existing producers.

Beneficial and Harmful Regional Arrangements

Regional trading arrangements can be beneficial or harmful depending on the degree to which producers are induced to shift from lower-cost to higher-cost sources (trade diversion), the extent to which reduced trade barriers permit greater economic efficiency in production (trade creation), the extent to which the FTA involves joint trade liberalization, and the ways in which other side-effects of a trading arrangement (increased competition, assurance that trade liberalization will endure, weakening or strengthening of the multilateral trading system) affect individual signatories to the FTA.

Perhaps this is best seen by examining the ways an FTA could negatively affect a country. Thereafter, an overview of the main features of FTAs is provided, and the ways in which each of them can affect the benefits and costs of an FTA agreement are considered.

Detrimental Regional Arrangements

Regional arrangements will be more detrimental, the more any increases in trade originate in commodities that were previously imported from countries outside the FTA (trade diversion) and the higher the tariffs to which those commodities were subjected.

Suppose, for example, that prior to formation of a United States-Mexico FTA, the U.S. imports clothing from Asia subject to a 25-percent duty, while Mexico imports chemicals from Germany with a 50-percent duty. After the FTA, the U.S. finds Mexican clothing (which can enter the U.S. market not subject to duty) 5 percent cheaper than Asian clothing (on which there is a 25 percent duty), while Mexicans find American chemicals (which can enter duty-free) 10 percent cheaper than German chemicals. The cost differential would, of course, be due to the absence of the tariff, and in each case the imports would be coming from a higher-cost source after the FTA than before its formation. Thus, the real costs of clothing imports to the U.S. would increase 20 percent and the real costs of chemical imports to Mexico would increase 40 percent.

Trade diversion can occur only when a country is originally importing from a third country: if all production is domestic and then imported from the partner country after the FTA, then trade creation is occurring. Note that trade diversion necessarily harms the importing country, but might provide a benefit to the exporting country. Thus, an FTA in which there was trade diversion of American imports from East Asia to Latin America, but no such diversion of Latin American imports, could be harmful to the United States and beneficial to Latin America.[14]

Most analyses of FTAs focus on potential trade diversion as the major cost of such an arrangement. However, other considerations suggest that an FTA might have more negative effects than suggested simply by the sorts of direct trade diversion discussed above. In the case of Latin America, one risk is that trade might initially be diverted from, say, Korea to Mexico when Mexico joins the FTA, and then diverted again from Mexico to Brazil when Brazil joins. To a degree, this is already happening

14. In effect, if the U.S. shifted to Latin American from Asian sources because imports from Latin America were duty-free, it would be equivalent to an improvement in the terms of trade confronting Latin America. It should be noted that trade diversion will occur only when the differential between the low-cost exporter's price and the FTA member price is less than the tariff on the good in the importing country.

with respect to the countries that became eligible for preferences under the Caribbean Basin Initiative (CBI): once it was known that the United States and Mexico would enter an FTA, some of the firms that had been induced to invest in the Caribbean countries because of CBI preferences shifted their activities to Mexico.[15]

There is one particular variant of trade diversion that could be costly for some Latin American countries. It is possible (and perhaps even likely) that some industries will spring up in response to preferential treatment that could not survive at free trade. If, for example, Colombia and Venezuela were to enter into a free trade agreement, it might pay producers in Venezuela to establish production of a new industry to compete in the two countries behind their tariff walls. Should Colombia subsequently liberalize trade multilaterally, the newly established Venezuelan industry could falter. This sort of trade diversion would be costly inasmuch as new investible resources would first be pulled into the industry and then rendered uneconomic. In addition, protection in the partner country's market may provide shelter for domestic firms from international competition, and thus be subject at least to some extent to the same difficulties as the import-substitution strategy.

Another potential cost to Latin America relates to domestic content requirements. These are the percentages of value added that must originate within the FTA in order to be eligible for duty-free treatment by the partner country. Domestic content requirements could induce domestic producers to shift their purchases of needed inputs from low-cost, third-country sources to higher-cost sources at home or in the partner trading country; this can affect costs and quality, and hence competitiveness in export markets.

Finally, when FTAs are sectoral (see below), they may simply enable the trading partners to perpetuate their protectionist policies and subject their domestic politicians to further protectionist pressures.

Beneficial FTAs

No FTA is going to be entirely trade-diverting. The more a country's imports already originate with an FTA partner and the lower its trade barriers prior to an FTA, the less costly trade diversion is likely to be. There is no question, however, that there are potential pitfalls of regional FTAs, although they can be avoided by unilateral trade liberalization.

When regional trading arrangements are among "natural" trading partners, the likelihood of gains from FTAs increases. Because each partner is already importing from the other, it is assured that the partner is a low-cost source of supply for the items being imported. For those commodities, removal of tariffs is almost guaranteed to result in gains for member countries.[16]

The pitfalls of regional arrangements are also smaller, and the potential gains greater, when the potential entrant to an FTA already has very low levels of protection. Indeed, the ideal arrangement

15. *Financial Times,* August 20, 1992, p. 3. See the further discussion of the CBI and trade diversion below.

16. Hamilton and Whalley (1985) found that tariff removal by a trading partner constituted the largest source of gain for countries forming regional trading arrangements.

would be for a potential entrant to be practicing free trade, and to enter into an FTA with another country for purposes of achieving greater assurance of market access, and greater integration of markets, than can be achieved simply by removing all trade barriers.

Thus, the European Community's move toward a "single market" was taken after internal tariffs had been reduced to zero and external tariffs, and tariff-equivalents of quantitative restrictions, were very low. Issues addressed were those that could further integrate trade: members agreed to accept each others' standards for most industrial commodities, thereby avoiding the need for duplicate inspections and the paperwork associated with them, as well as different makes and specifications for different European markets.

Moreover, in circumstances where trade barriers are already very low, an FTA can serve as a "commitment" to investors that trade policies will remain liberalized. This can be an important source of gain for countries that have recently reformed their trade and payment regimes; a major source of difficulty in the transition to an outer-oriented economy can arise if investors are hesitant because they fear that the newly liberalized trading regime will not persist. In those circumstances an FTA may accelerate and increase the benefits of an outer-oriented trade strategy.

FTAs can also be beneficial, even for existing trade levels, when they result in trade liberalization for commodities where comparative advantage exists. Thus, if Mexico is already exporting clothing to the United States that is subject to a 25-percent import duty, and if the FTA results in the (gradual) elimination of that duty, Mexican producers stand to gain by that liberalization.

There is one additional circumstance in which an FTA may prove beneficial. When a "natural" trading partner of a small, open economy becomes increasingly protectionist vis-a-vis the rest of the world, formation of a regional trading arrangement may provide "insurance" that any increase in protection will not adversely affect the small open economy. That was certainly a motive for Canada to form the Canada-United States FTA.[17] Even then, the precise structure of the agreement can significantly influence the amount of "insurance" obtained through FTA formation.

Assuring a Beneficial FTA

Discussion of the domestic economic policies that are likely to benefit Latin American countries joining FTAs is deferred to the next section. Here the focus is on aspects of FTA arrangements that can reduce the risk of countries entering arrangements that result in economic losses.

A good starting point is to note that "natural trading partners" are potentially better members of an FTA than are those in which there are few (or, as in the extreme example, no) commodities of which each is the low-cost external producer for the other. An FTA with the United States makes a great deal of sense for Mexico,[18] for example, because the U.S. is the low-cost source for about 70 percent of

17. See Rugman and Anderson (1987).

18. Since this paper is addressed to a Latin American audience, the issue of whether the United States would benefit is not addressed here. Note that, at least in the case of Mexico, trade diversion could represent a potential cost to the U.S., whereas there are fewer items for which Mexicans are likely to substitute high-cost U.S. sources

Mexico's imports. Mexico in effect reduces its tariffs and quantitative restrictions on imports from its low-cost source and in addition benefits from reduced U.S. trade barriers to imports from Mexico. Mexico's tariff rates are also very low, which means that there can be few items for which the regional preference shifts sources to the U.S. because of the margin of the tariff.[19]

For other Latin American countries, the share of trade with Canada and the United States is less than Mexico's. Nonetheless, it is significant, and if tariffs and other trade barriers are already very low or nonexistent, the potential for gain through joining a Western Hemisphere FTA may be substantial. Also, the United States has relatively low tariffs, and the costs of shifting to a higher-cost source will be smaller than if tariffs were higher. If the FTA provides reasonable insulation against American administered protection, and if it meets the desiderata discussed below, it can increase producer confidence that export markets will remain open and hence encourage domestic and foreign investment. It can therefore also contribute to accelerated economic growth.

However, the extent to which an FTA can accomplish this depends both on the extent to which it is GATT-plus (rather than a move away from the multilateral trading system toward trading blocs) and on some technical aspects of the agreement. It is to these latter that we now turn. Several items need to be considered: (l) the extent to which all members of an FTA are on an equal footing and potential entrants may join, (2) the degree to which the arrangement is a uniform, across-the-board agreement, as contrasted with sector-specific arrangements, (3) the restrictiveness of rules of origin, and (4) the extent to which the agreement provides protection against "administered protection" and other nontariff trade barriers.

1. **Equality of members and access to membership.** An ideal GATT-plus arrangement would be one in which members subscribed to all the GATT codes, subscribed to further trade-liberalizing measures among themselves, and agreed to permit as new entrants any other countries that will adhere to the same agreements on the same terms.

While in practice the ideal cannot be fully attained, a regional trading arrangement that does not envisage new membership on equal terms with existing members (perhaps after a period of transition) has a number of drawbacks. From the perspective of trading partners with the United States, there was for a time a risk of a "hub-and-spoke" system.[20] It appeared that the U.S., having formed an FTA with Canada, might form a separate bilateral FTA with Mexico and other separate bilateral arrangements with other Latin American countries.

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for lower-cost East Asian or European ones.

19. Mexico currently has quantitative restrictions on some major agricultural commodities which are quite highly protected. Those commodities are primarily temperate grains, in which it would appear that the United States is a low-cost producer. To the extent that Mexico opens up grain imports, its long-run gains will be greater since the U.S. is probably a low-cost supplier and, in addition, resources can be more productively used in Mexico.

20. Wonnacott coined the phrase to describe a situation in which a central trading partner had duty-free access to imports from a large number of countries, but each other country had duty-free access only to the central trading partner's products. As Wonnacott pointed out, such a system would give producers in the central country a cost advantage whenever low-cost components and parts subject to duties were sourced in more than one country. See Wonnacott (1990).

As Wonnacott noted, a hub-and-spoke system would work to the disadvantage of producers in all countries except the center (unless, of course, the partner countries made their imports duty-free). Producers in the hub country would have duty-free access to intermediate goods from whichever partner were lower-cost, whereas each partner would have duty-free access only in the hub-country market.[21] That in itself is reason enough to conclude that a beneficial FTA would be multilateral, rather than bilateral.

There is, however, (as already mentioned) a second potential source of difficulty when access to an FTA is uncertain. Investors may begin production in a country belonging to an FTA because of the tariff margin of preference. If another country subsequently joins the FTA on the same or even more favorable terms, investors may be tempted to shift production to the second country. One could, therefore, build in instability to foreign investment if accession of other countries were uncertain.

This trade and investment diversion has already been a source of concern for the Caribbean countries.[22] The United States extended unilateral duty-free preferences to those countries (over and above GSP treatment) in 1983, and factories were subsequently built to take advantage of that status. When the negotiations for an FTA with Mexico were announced, the beneficiaries of Caribbean Basin Initiative preferences protested, and several potential foreign investors shifted to Mexico in anticipation of the new FTA. In a similar way, Mexico will face the risk that some lower-cost source will subsequently form an FTA and divert trade and production. This would not only constitute a waste of resources, but would also lead to misunderstandings unless it is recognized in advance that new members will accede to the FTA on similar terms.[23]

If investors know that there can be other entrants to an FTA, investment and production decisions will be more firmly based on sound cost evaluations than if these issues are not resolved. Since the ultimate objective is an open, multilateral trading system, a more open FTA accessible to all who subscribe to its conditions is desirable and should be part of the initial agreement.[24]

Considerations suggesting equality of treatment and terms of accession also point to a potential danger of some FTAs: there is a considerable risk that when trade-diverting investments are made because of an FTA, the investors in those industries then become opponents to any further trade liberalization.

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21. To be sure, this disadvantage would disappear if a country reduced its tariffs to zero.

22. See Krueger (1993), Chapter 7, for a full description.

23. Reaching an understanding on the potential for East Asian exporters to join the FTA will be especially important, in light of their competitive position vis-a-vis Latin American countries. On economic grounds, diversion of trade from lower-cost to higher-cost sources is not efficient. Moreover, it is arguable that in the longer run it is not compatible with healthy economic growth in the countries to which production and trade are diverted.

24. It can be argued that the Canadians lost out by assuming that theirs would be the only FTA formed by the U.S. As such, they negotiated for some items, the value of which to them may be significantly reduced as a consequence of other FTA arrangements. See Wonnacott (1991) for an analysis.

This should be a source of concern in regional arrangements such as MERCOSUR that have been entered into presumably as a step toward fuller regional integration. Insofar as MERCOSUR provides producers with a larger protected market behind high walls of protection, the opposition to removal of that protection will be even greater in the future, especially if new industries spring up behind protection levels higher than would be consistent with entry into WHFTA.

2. **Across-the-Board vs. Sectoral Arrangements.** An FTA is more likely to be beneficial, the more it is compatible with uniform, across-the-board incentives and the less scope it leaves for government policies to affect the relative profitability of alternative activities. The more activities there are that are singled out for special regimes within an FTA—such as autos, coastal shipping, "cultural activities," agriculture, and oil—the less will the FTA be trade-liberalizing and the smaller its potential benefits.

Even if there are concerns about the ability of particular sectors to adjust, it is probably preferable to have a slower but uniform schedule of transition to duty-free entry, rather than to single out particular sectors for special treatment for an indefinite period.

Not only is bargaining for special provisions for individual sectors likely to strengthen domestic special interests, but it also opens the door for protectionist pressures to operate in the counterpart country. Thus, while there may be particular concerns about Caribbean ethanol, for example, it should be remembered that the quid quo pro for special treatment of that activity is likely to be special treatment of an activity or sector in the partner country. Moreover, once such treatment is accorded to a sector, other pressure groups will demand similar treatment.

One of the main benefits of a WHFTA should be to provide assurances against further protectionist pressures in the United States. This would enable Latin American producers to undertake promising investments with assurances that they will not encounter newly erected trade barriers if they are successful in achieving low-cost production. One of the objectives of a WHFTA should therefore be to provide the minimal possible scope for protection; that, in turn, implies that there should be as much across-the-board, and as little sectoral, arrangement as possible.

3. **Rules of Origin.** FTAs and customs unions both have rules of origin to determine what products are and are not eligible for preferential treatment under the trading arrangement. Unlike customs unions, however, FTAs permit individual members to maintain their own external tariffs and thus permit different tariff levels between countries.

The higher the percentage of content required by rules of origin, the more disadvantageous the arrangement. This is more so, the less industrialized and smaller the country and the higher the trading partner's tariffs. To see this, imagine a labor-intensive assembly process in a small developing country where most inputs are imported, processed, and assembled domestically. Assume further that these inputs are imported pre-FTA at zero duties, that domestic costs of assembly constitute 35 percent of the export price, and that the assembler is already a low-cost supplier exporting to the rest of the world. If the center country has a tariff of 10 percent, and the FTA requires 50 percent local content to be eligible for importation duty-free, the assembler would have several choices: he could export to the partner country but have his product subject to the duty; he could substitute domestic (presumably higher-cost) components for previously imported ones; or he could import (again, presumably higher-cost) components from the partner country. If length of production run is a consideration in the producer's low-cost advantage worldwide, the firm would have either to shift completely to local sourcing, thereby raising costs, or have two production runs, one with the FTA-sourced components to meet the 50-percent requirement, and one with foreign-sourced components for third-country markets. This would also raise costs.

It may be noted also that the higher the rule-of-origin domestic content requirement, the more costly it can be to local producers relying on imported parts and components from non-FTA countries. Similarly, the higher the importing country's tariff to non-FTA members, and the larger the share of the importing country in the total exports of the assembler, the greater the costs will be. While there is little that Latin American countries can do about North American tariff rates, they can negotiate for more liberal rules of origin. These rules are far more important for small developing countries than they are for large, advanced countries, and as such, higher FTA content requirements constitute protection to producers within the FTA, especially the large industrialized country.

4. **Dispute Settlement and Minimizing Liability Under Administered Protection.** It has already been noted that providing domestic producers with assurance that large importing countries will not erect trade barriers against them is one of the major contributions an FTA can make to the growth prospects of Latin American countries.

For a WHFTA, by far the largest importing country is the United States, so achieving as much insurance as possible from U.S. protectionist measures should be a major objective of FTA negotiations. Since in recent years U.S. protection has increasingly been "administered" in the form of antidumping and countervailing duty provisions, a major objective of FTA negotiations should be to seek as much insulation as possible from these measures.[25]

The Canada-United States agreement contained clauses that provided some insulation for Canadian producers, and a joint tribunal for deciding cases in which there were disputes. It will be desirable to extend these mechanisms multilaterally across members of WHFTA for three reasons. First, those mechanisms are already in place. Second, there is considerable potential for confusion if rulings by different dispute resolution panels are different. Third, a multilateral dispute-resolution mechanism will provide a counterweight to the U.S., which has considerably greater bargaining power vis-à-vis any individual country than it does vis-à-vis all other members of a WHFTA.

Ultimately, protection arising from unfair trade laws can be mitigated in two ways. First, the United States could unilaterally abandon or reduce resort to these practices. As an alternative, signatories to the FTA could negotiate common domestic fair-trade legislation that would obviate the political pressures for these measures within the U.S. Until one or both of these paths is taken, administered protection will remain a problem for partners in a WHFTA.

Domestic Economic Policies Compatible with an FTA

All of the issues discussed above are subject to negotiation at the time of entry to an FTA, and as such are not entirely subject to the wishes of Latin American participants. Bargaining, by its nature, must

25. For an analysis of administered protection and how it operates, see Boltuck and Litan (1991).

entail some giving in on issues of importance by both parties. While Latin American countries should weigh the desirability of across-the-board arrangements, open accession provisions, liberal rules of origin, and a flexible dispute settlement mechanism figure heavily in deciding on their negotiating stance, they do not themselves control the precise form of a WHFTA.

By contrast, Latin American countries can alter their domestic economic policies in ways that are conducive to greater gains from trade and provide at least some protection against possible inefficiencies that might arise from trade diversion under an FTA. Two sets of economic policies require attention: (l) the consistency of overall macroeconomic and exchange-rate policy, and (2) the openness of the potential FTA member's overall trade regime.

1. **Consistency of Macroeconomic and Exchange-rate Policies.** When two countries that trade little with each other form an FTA or customs union, there need be little concern about harmonization of any domestic economic policies: trade with the rest of the world dominates that between the pair of countries. When, however, there is significant trade within the regional agreement, the very existence of the arrangement obliges that economic policy be appropriate. In addition, the openness of the overall trade and payments regime greatly influences the potential for gain under an FTA.

Developing countries following policies of import substitution have in effect insulated their economies from the rest of the world through import prohibitions and quantitative restrictions. They have therefore often had exchange-rate policies that were inconsistent with their domestic macroeconomic policies for significant periods of time. While the costs of those inconsistencies have been high, they have not been nearly as great as would be the case under an FTA once quantitative restrictions are removed and intra-FTA tariffs eliminated.

To maximize the gains from an FTA, each country will need to insure that its exchange rate is realistic. Usually, when there are high walls of protection surrounding imports, removal of that protection implies a surge of imports. To offset part of this surge and to encourage the expansion of exports to finance the remainder, a change in the real exchange rate is normally essential. Without such a realignment, import-competing industries face too much competitive pressure, and exportable industries have insufficient incentives for expansion.

Once an FTA is in place with a realistic exchange rate, either exchange-rate (and interest-rate) policy must compensate for inflation differentials, or domestic macroeconomic policy must assure a domestic rate of inflation very close to that of partner countries.[26] Because imports may enter from the partner country freely, a small difference in inflation rates at a fixed nominal exchange rate can lead to large shifts in demand between domestic and foreign producers. The world was given a dramatic view of the importance of exchange-rate policy when Germany adopted an exchange rate for unification that left most firms in the East unable to cover even marginal costs at West German prices and the chosen

26. It is highly improbable that a meaningful FTA could be formed without full convertibility of currencies on current account among trading partners. Individuals would have to be free to buy and sell in each others' currencies for the FTA to be meaningful. In turn, that implies that quantitative restrictions on imports could not be used to bring about the desired balance between foreign exchange expenditures and receipts. For some Latin American countries, this requirement would necessitate a significant change in exchange rate policy.

exchange rate.[27] The same effects will occur between any new entrant to a WHFTA and the United States and Canada should exchange rates initially be incompatible with the current price and cost structures in the partner countries. And even when they are compatible, it will be essential to keep them that way, and this stability will require either convergence of inflation rates or very quick adjustment of the exchange rate to inflation differentials.[28]

It is likely to be desirable for FTA members to bring about capital-account convertibility fairly rapidly.[29] Whether they do so or not, however, it will be essential that nominal interest rates in member countries reflect inflation differentials: if they do not, the opportunities for shifting monies to the country with the higher expected real interest rate are simply too great once trade is fully liberalized. Exporters may delay repatriation of their receipts, and importers may alter the timing of their payments; citizens can choose the timing of their travel; and a thousand other ways will be found to transfer resources to the place where the real interest rate appears higher. To attempt to control these transfers by regulating exports and imports is inconsistent with an FTA and essentially obviates any possibility for a successful outward-oriented trade strategy. Effective controls are simply too costly.

Hence, both exchange-rate and interest-rate policies must be firmly based on realistic expectations about domestic monetary and fiscal policy. Since all policy makers tend to err in the direction of optimism, it is probably desirable that countries joining an FTA initially opt for a crawling-peg exchange rate where it is expected that adjustments will cover inflation cost differentials and may also be used to bring the real exchange rate to a realistic level, and for an interest-rate regime consistent with anticipated inflation and exchange-rate behavior. Then, when domestic macroeconomic policy has achieved convergence of inflation rates, a crawling peg can, first de facto and then de jure, become a fixed exchange-rate regime.

2. **Other Domestic Economic Policies.** It has been repeatedly emphasized that the lower a country's tariffs and other trade barriers at the time of joining an FTA, the greater the potential for gain and the smaller the potential for harm. Since FTAs constitute part of the trade regime, it is not surprising that the nature of protection is perhaps the most important single economic policy that can affect the benefits and costs of joining an FTA.

However, all of the other policy changes normally associated with "policy reform" and structural adjustment in developing countries can increase the benefits accruing from an FTA. Reviving and insuring adequate infrastructure in ports, domestic transport, communications, and power are essential both for domestic economic growth and for permitting those with sufficiently low costs to be able to succeed in export markets.

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27. See Akerlof et al., 1991.

28. There need not be full capital account convertibility for this proposition to hold. Indeed, a major concern is—and should be—that current levels of production may be needlessly disrupted, even in industries with strong comparative advantage, if the exchange rate is not realistic.

29. Capital account convertibility means the right of anyone (domestic or foreign) to ask for, and receive, foreign currency in exchange for local currency at the prevailing exchange rate. For technical definitions, see *Yearbook of Exchange and Trade Restrictions*, 1992, The International Monetary Fund, Washington, D.C. Most developed countries' currencies are convertible for both current and capital account transactions, usually without restriction.

A first prerequisite of an FTA is a consistent set of exchange-rate, macroeconomic, and interest-rate policies. That insures that gains are possible, and that avoidable damage to domestic production and employment will not occur. The second prerequisite is removal of trade barriers to insure that trade diversion will be minimal and that membership in the FTA will be consistent with an overall outward-oriented trade policy. That in itself is, of course, growth-promoting. This last set of policies regarding infrastructure is not, strictly speaking, necessary to FTA membership, but it certainly affects the size of the gains that can be realized from a more outward orientation and FTA membership. There is little benefit from exporters' realizing lower costs if their shipments will be detained for unpredictable and variable periods by delays in domestic transport or at port. Reliability and speed of communications between suppliers and buyers are essential for success in selling most modern industrial goods. Similarly, a 10-percent reduction in the costs of domestic shipping can be more valuable to potential exporters than a change in the real exchange rate, affecting as it would both their costs of inputs and their receipts from exports.

Appropriate attention to domestic infrastructure is essential for a resumption of growth. The payoff for investing in appropriate facilities can, however, greatly increase in the context of an assured open international market.

Negotiating an FTA From a Latin American Perspective

Given the importance of Canada and the United States in world trade, it is very likely that Latin American countries will experience net trade creation as they join an FTA and simultaneously benefit from assurances that U.S. and Canadian markets will remain open to them. The challenge in negotiating an FTA is to assure maximum openness of Canadian and U.S. markets (as well as other Latin American markets). That in turn implies the necessity for an across-the-board arrangement to prevent special-interest groups in partner trading countries from pressuring for particular arrangements for their sectors.

As the preceding sections make clear, Latin American countries that have already liberalized their trade regimes and stabilized their macroeconomic and exchange-rate policies stand to gain the most from joining a WHFTA. Trade liberalization takes priority: if macroeconomic stabilization is gradual, a consistent crawling-peg exchange rate policy can enable an FTA to provide gains even as macroeconomic stabilization proceeds; by contrast, without prior trade liberalization the adjustment costs of an FTA will be greater, as will the potential for trade diversion, once an FTA is formed. Moreover, countries that have liberalized their trade regimes will themselves have fewer pressure groups seeking exemption from the FTA if they have already liberalized their economies. That, in turn, will permit a stronger negotiating position vis-à-vis pressures for negotiation sector by sector from other FTA members. In regards to all economic policy measures, it is important that all economic policies immediately be based in part on avoiding measures that will promote special interests that might oppose an FTA.

This is especially a consideration for subregional FTAs, for which there exists a real danger that the low-cost regional producers will expand their capacity to sell within the regional FTA, and recognize that they will lose that market if a hemispheric FTA is negotiated. Subregional FTAs could be beneficial if they accelerate the process of trade liberalization prior to entering a hemispheric agreement, but the risks of building in new sources of opposition to an FTA (and strengthening opposition of existing groups) are substantial.

It is in the long-term interests of all Latin American countries to create a WHFTA that is open and accessible to new entrants on roughly the same terms as those on which existing members entered. It is in this connection that regional unity may well permit a better result for all than could be expected from individual bargaining for particular terms for each country.

It is also important to negotiate as low a domestic-content requirement as possible within the FTA, and to take domestic measures on such issues as health and safety standards that will preclude restrictionist measures evoked on their account.

If an open, across-the-board WHFTA can be negotiated within the Western Hemisphere, and if it strengthens the GATT and the open multilateral trading system, the opportunities for improved economic performance will be great. More rapid economic growth throughout the hemisphere could result and in turn spur increased trade within the region and with the rest of the world—much as in the European Community in the 1950s and 1960s. The benefits from such a "GATT-plus" arrangement could be substantial to all members and simultaneously contribute to the growth and stability of the open, multilateral trading system.

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IS A GENUINE PARTNERSHIP POSSIBLE IN A WESTERN HEMISPHERE FREE TRADE AREA?

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Free Trade Areas and the GATT

Trade Creation and Trade Diversion: Net Costs and Benefits

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

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

FTAs and Multilateralism

The debate of whether trade creation will be dominant over trade diversion, or vice-versa, is linked (although not always clearly) with the description of regional blocs as being either "stepping stones" to global trade liberalization and trade expansion, or else becoming "fortresses" and thus acting as obstacles to multilateral liberalization. This will depend on how the FTA is designed—in particular whether it strictly complies with the General Agreement on Tariffs and Trade (GATT) rules under Article XXIV that tariffs and other trade barriers against outsiders should not be increased and that the agreement must apply to "substantially all" intrapartner trade. It will also depend on whether formation of the FTA takes place in an international climate of progress toward multilateral liberalization or is adopted in response to breakdowns and frictions that frustrate the pursuit of multilateral negotiations.

Given that the WHFTA proposal originally came at a time of great uncertainty and lack of progress in the multilateral liberalization sought in the Uruguay Round, the GATT was clearly worried about the potential trade diversion or other negative effects of a WHFTA, as indicated in its 1992 review of United States trade policy. The GATT cites illiberal and protectionist features and tendencies in U.S.

1. The author gratefully acknowledges research assistance from Nicholas Georgiadis.

trade policy (especially in antidumping action and countervailing duties, and unilateral actions under Section 301) which it fears are indicators that WHFTA might be an instrument of trade diversion and undermine the most-favored-nation (MFN) principle. On its part, the U.S. has reaffirmed its commitment to a strengthened multilateral trading system (MTS) and clearly wishes the WHFTA to be considered a stepping-stone toward such a system and an instrument of trade creation. Article XXIV of GATT, which permits full free trade areas with 100 percent free trade within the area (although not partial regional preferences—the logic of this is not entirely clear), is based on the latter assumption, i.e., that the free trade area is formed in the context of movement toward global multilateralism as represented by GATT.

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

Pros and Cons for Latin America

From the point of view of LAC countries, the relationship between WHFTA and the MTS is uncertain. Multilateral trade liberalization will dilute the benefits of WHFTA for LAC and also for North American exporters to Latin America. On the other hand, multilateral liberalization will help LAC exporters in third markets, and they will also benefit from a general trade expansion and rising incomes. This is simply another "netting out" of pros and cons, and the results may be different for each country. The future success or failure of the MTS is more or less a datum for LAC countries beyond their reach of influence, and a scenario of no MTS and no WHFTA would be worse for Latin America than either MTS and no WHFTA or WHFTA and no MTS.

From the Latin American point of view, the chief attraction of WHFTA and the MTS is that it would prevent the marginalization that would result if the three big regional blocs in North America, Europe (including Eastern Europe and continued preferential treatment of Lomé countries), Japan (with the NICs and coming NICs in East and Southeast Asia) frustrate the MTS. This would be dangerous and unfavorable for Latin America. If such marginalization were combined with continued slow growth of the world economy, growing protectionism, continued debt pressure, and unfavorable terms of trade, the outlook would be gloomy indeed. By contrast, the WHFTA appears to offer an escape, albeit a second-best solution.

Difficulties in Predicting the Outcome

Dynamic Comparative Advantage

The problem of netting out the positive effects of trade creation and the negative effects of trade diversion is one of the reasons why it is difficult to predict the ultimate impact of a WHFTA. Another reason relates to the fact that the trade creation based on existing static comparative advantages is only one part of the benefits expected from an FTA. The advocates expect equal or greater trade creation from the increase in efficiency of production and the development of new dynamic comparative advantages that trade creation is expected to bring—longer production runs, increased specialization, investment in specialized machinery, etc.—and the associated benefits of transfer of technology and increased investment.

Such dynamic advantages are difficult to predict and impossible to quantify. The same is true of the dynamic disadvantages and vicious circles that might follow in the wake of the harmful effects of trade diversion or marginalization. Estimates of dynamic gains have been made in connection with NAFTA, but their applicability to WHFTA is limited by the fact that the dynamic gains to Mexico arise in part from the displacement of other Latin American exports that would not apply under WHFTA. These dynamic comparative advantages are the most important for sustainable development. They are largely created rather than natural. Thus it is crucial that LAC countries, not passively accept the opportunities arising from location or natural resources. They must use the restructuring that will inevitably be required for a WHFTA to create new dynamic advantages, as Japan and Korea have done. This will require vigorous trade, industrial, education, training, and technology policies and careful selection of—and concentration on—priority sectors. Such policies can and should be market-friendly, but they require more than blind reliance on the market.

A Radical Change

The second reason why the ultimate effects of WHFTA are difficult to foresee is that it will be a far greater change in economic trading relations than theories and economic models are able to deal with. These tools are appropriate for dealing with relatively small changes in circumstances, not revolutionary upheavals such as WHFTA, given its large scale and the fact that it is part of a trade, investment, and debt-reduction package launched in 1990 under the Enterprise for the Americas Initiative (EAI). WHFTA is not really trade creation, but development creation.

Welfare Effects of WHFTA

The welfare-increasing and welfare-reducing effects of WHFTA must be carefully defined. A WHFTA could be welfare reducing for the countries outside, but welfare increasing for the Western Hemisphere. It could even be welfare increasing for some parts of the hemisphere but welfare reducing for other parts, plus welfare increasing for some sectors but welfare reducing for others; such as welfare increasing for large-scale modern producers within one sector but welfare reducing for small-scale producers in another sector. In theory the net effect of gains and losses can be balanced by compensating the losers *(Pareto optimum).* Such compensation arrangements are politically difficult to negotiate, and the compensation process itself may set welfare-reducing forces into motion.

If the WHFTA becomes a "fortress," the effects could be welfare reducing in the long run, even in the absence of retaliation from Europe or Japan. The difficulty of predicting overall net effects is heightened by making different assumptions about alternatives to WHFTA. Is the alternative the present status quo? Is it a continuing multilateral liberalization? Is it strengthened or weakened regional cooperation within Latin America? To what extent will Japanese and Western European investment flows be diverted to Eastern Europe and the Commonwealth of Independent States? Will domestic opposition among more immediate losers in both North and South America be overcome in welfare-efficient ways, or will it lead to distorting exemptions, injury clauses, and embittering trade disputes?

While different assumptions can be built into models constructed to forecast the impact of WHFTA, no model can correctly produce the actual future mix of economic and political circumstances that will determine the outcome. Even at a future date we can never be sure: what would the situation of LAC countries have been in the absence of a WHFTA, or with a differently constructed WHFTA? Counterfactual evidence is notoriously difficult to pin down and open to subjective judgements. Thus, if WHFTA is designed as a counter to possible West-East European or Japan-East Asian integration plans, analysis will be based on a double counterfactual speculation, namely, (1) what would be the impact on the Western Hemisphere of any such European or East Asian integration; and (2) what would be the impact of WHFTA in an assumed world of European and/or East Asian integration? (The "and/or" in the preceding sentence indicates the possibility of not one, but three counterfactual situations with which Western Hemisphere countries could be faced.) Could WHFTA provoke the very European and/or Asian bloc integration against which it may be designed as a defense? Will the existing preferential agreements with nonhemispheric countries, under the GSP or otherwise, be maintained or modified while the WHFTA is established? Would the alternative be increased U.S. protectionism? Will the FTA be accompanied by increased aid or investment? The number of possible scenarios is large, and each change in scenario will significantly alter the impact on Latin America.

Who will Seize the Opportunities?

The issue of trade efficiency adds to the difficulties of predicting the impact of WHFTA. It is not simply a question of analyzing the new opportunities that may open to LAC countries in the North American market and assessing their distribution among different LAC countries. The ability of different countries to seize opportunities is another important factor, and the latter is far more difficult to predict than the former. In the past, opportunities for manufactured exports were probably very similar for the East Asian tigers as for Latin America, but the former proved to be better at seizing their opportunities (and to some extent pre-empting them).

The Special Nature of WHFTA

Theory and Practice: Who Benefits from FTAs?

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

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

However, this argument is founded on various simplifying assumptions: perfect competition, full employment, constant returns to scale, and perfect mobility of factors of production across sectors. These assumptions do not correspond with reality. To understand the nature of the problem requires going beyond simplifications to observe that there exist a number of factors that are likely to cause relatively less-rapid growth (or even decline) among the poorer members of an integration arrangement. Capital may flow from poorer to richer areas because of their greater availability of economic infrastructure, access to specialized services, proximity to large markets, greater relative development of capital markets, and greater institutional and administrative capability.

Also, widening of markets due to trade liberalization in an integration scheme will often give competitive advantages to the industries in the more advanced regions. Under these conditions, initial differences in productivity and economic development can lead to "circular and cumulative causation" and growing polarization between the members of an integration scheme: the creation and perpetuation of inequalities that Hirschman calls "polarization" and Myrdal the "backwash." Myrdal and Hirschman believe that the play of market forces tends to increase, rather than decrease, inequalities between regions in an integration arrangement. If, for instance, a region is not attractive for investment, it will tend to enjoy less technological progress and benefit less from economies of scale than other regions; it will become even less attractive for foreign investment. Furthermore, in order to take advantage of the positive or "trickle-down" effects of the wider market, a poor region must have developed its infrastructure, human capital, and administrative and institutional capability to a level that will allow the region to benefit from growth stimuli from prosperous regions.

Political reality adds yet another dimension to the issue. Regional arrangements have suffered—and sometimes fallen apart—because of dissatisfaction of weaker partners with a concentration (real or imagined) of the benefits of the integration in the better-off countries. The real economic reason for this is that the stronger countries have better infrastructure, technology, skills, transportation, and industrial base to take advantage of new trading opportunities and larger markets as well as to withstand intensified competition from abroad. They will also be more effective in negotiations to shape the FTA agreement to take account of their national interests and in subsequent dispute settlements. It has been suggested that the stronger partner will use superior bargaining strength and negotiating capacity to extract "side payments" on other related matters.[2]

Unequal Partners in WHFTA

Labor productivity and per capita income. Labor productivity in manufacturing (measured by value added per worker in 1990) in Latin America was less than one third of that in North America. This difference was greater than that between labor productivity in Western Europe versus that in Eastern Europe and the former USSR, where the differential is a little over 2:1, but less than that between Japan and East and Southeast Asia, which is closer to 4:1. It should be one of the objectives of WHFTA to

2. G. K. Helleiner, *Toward a New Regional Development Strategy for Latin America in the 1990s.* Prepared for a panel discussion at the Inter-American Development Bank Conference on Latin American Thought: Past, Present, and Future, Washington, D.C., November 14-15, 1991.

reduce this 3:1 differential. The discrepancy in per capita income levels is even greater, of the order of 7:1.

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

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

Comparison with other potential blocs. North America would also be the larger partner in terms of the volume of manufacturing employment (20 million versus 10 million). This is in sharp contrast both to the situation in Europe, where manufacturing employment is in fact larger in Eastern Europe and the former U.S.S.R. than in Western Europe, and also to the situation in East Asia, where manufacturing employment in Japan is smaller than in East and Southeast Asia. As far as sheer weight of numbers is concerned, the importance of the advanced "core" in relation to the "periphery" is greater in the case of the WHFTA than in the two other potential blocs. This means that while the impact of WHFTA on North American employment and the U.S. economy in particular may be small and submerged by other economic trends and events, the impact on the LAC economies would be major and has to be carefully analyzed and anticipated.

Export coverage. For the United States, the extension of the free trade area from Canada to the rest of the hemisphere is a relatively small step in terms of export coverage, even including Mexico, from 21.0 percent by an additional 13.5 percent; whereas for the LAC countries the extension from Latin American preferences to WHFTA is a very major step: overwhelmingly so for Mexico (from 7.6 percent by an additional 66.0 percent) and Venezuela (from 9.0 percent by an additional 56.6 percent), and for Brazil (from 12.9 percent by an additional 28.9 percent). From the point of view of the U.S., the big steps

3. See S. Griffith-Jones, C. Stevens, and N. Georgiadis, *Regional Trade Liberalization Schemes: The Experience of the ECC.* IDB-ECLAC Project Working Paper WP-TWH-47, June 1993.

in regional integration have already been taken. From the point of view of LAC countries, the big steps are still to come.

Country diversity. One might expect the impact of WHFTA on individual LAC countries to depend largely on the share of their exports to the United States and Canada. This is highest for Mexico (66 percent), Venezuela (57 percent) and Ecuador (46 percent); considerable for Brazil (29 percent), Colombia (41 percent) and Peru (32 percent); but low for Argentina (24 percent), Bolivia 817 percent), Chile (19 percent), Uruguay (12 percent); and virtually nonexistent for Paraguay (4 percent). However, it would be a very static assumption to make that countries would benefit from WHFTA in the same order. On a different reading, a low share could be taken to indicate the existence of a large unused potential that could reverse the order of benefit. Exports to nonhemispheric countries are over half of total exports for Argentina (65 percent), Brazil (58 percent), Chile (67 percent), Paraguay (54 percent) and Uruguay (61 percent); and under half for Bolivia (25 percent), Colombia (43 percent), Ecuador (33 percent), Mexico (26 percent), Peru (49 percent) and Venezuela (34 percent). These figures could indicate the various degrees by which LAC countries would be affected by any "fortress" developments in WHFTA and possible retaliation by outside countries.

Imports from the U.S. also form the highest share of total imports in Mexico (66 percent) and Venezuela (43 percent); range between 30 percent and 40 percent in Colombia and Ecuador; between 20 percent and 30 percent in Bolivia, Brazil, Chile, and Peru; and below 20 percent in Argentina, Paraguay, and Uruguay. These figures indicate considerable variations in reliance on imports from the U.S. Dependence on imports from outside the hemisphere is highest in Brazil (64 percent); between 40 percent and 50 percent in Argentina, Chile, Ecuador, Paraguay, Uruguay and Venezuela; between 30 percent and 40 percent in Bolivia, Colombia, and Peru; and lowest (28 percent) in Mexico. By comparison, U.S. hemispheric exports to Latin America were under 10 percent of total exports (although this figure jumps to 35 percent, comparable to the share of hemispheric exports by Argentina and Chile if Canada is included). Similarly, the share of U.S. imports from Latin America is only 12 percent, and the hemispheric share, even with Canada included, at 29 percent is still lower than that of any LAC country. Naturally, these aggregate figures acquire real meaning for an assessment of the impact of WHFTA only when broken down by categories of goods. This further analysis is beyond the scope of this paper.[4]

Is a Genuine Partnership Possible?

Conditions to be Met

Strengthening trade creation. The trade-creation effect of a WHFTA would be strengthened by the free flow of investment and removal (or reduction) of distorting external pressures like the perverse payments arising from debt servicing (both included in the EAI proposal) and also by improved transport and information links within the area, freer movement of labor and stable, satisfactory terms of trade and commodity prices (none of which were mentioned in the EAI message). Entirely free movement of labor is clearly not a politically realistic expectation; what is under debate is the extent of controls on the movement of labor including the "brain drain." The ideal objective would be to reduce the incentive to

4. See Refik Erzan and Alexander Yeats, "Free Trade Agreements with the United States—What's in it for Latin America?" The World Bank, Policy Research Working Paper Series 827, January 1992.

migrate from South to North by providing productive employment and better incomes in the South while also liberalizing as much as possible conditions for entry into the North.

However, there seems to be a tendency to avoid this subject by tacitly assuming that creation of employment in the South would have no impact on employment in the North. This is not the case. To some extent it is unavoidable that the increased employment and increased exports from the South will be at the expense of unskilled labor in certain industries and regions of the North. While the prospect is that the net effect on employment in the North will be beneficial, both through increased employment in technology-intensive and skill-intensive industries and as a result of a general expansion of trade and rise in income. But there are bound to be losers among certain categories of workers and in particular industries. These losses will call for adjustment and good social and compensatory policies in the North to avoid popular and Congressional hostility to a WHFTA agreement (even though such a protectionist backlash would be the worst possible response). The U.S. Trade Adjustment Act would have to be strengthened and effectively implemented. Such adjustment, often from manufacturing into service industries, may result in lower wages for some groups of U.S. workers.

Terms of Trade

The question of terms of trade and commodity prices is particularly important to LAC countries in view of their frequent and recent experience of "immiserising trade expansion," i.e., expansion of export volume accompanied by falling or stagnant export revenue and/or real earned import capacity, as a result of falling prices and deteriorating terms of trade.[5] During 1985-90, export volume expanded at an annual rate of 4.3 percent, but all these additional revenues were wiped out by deteriorating terms of trade. There was no increase in earned import capacity at all. This experience has not been limited to exports of primary commodities, but has also extended to their trade in manufactures.[6] Trade expansion may be a rational objective in itself for the world as a whole and for both partners taken together, but for an individual trading country it is only a rational objective if it leads to additional earned import capacity. (There is a qualification to this statement: insofar as employment creation is an objective in itself, the expansion of the volume of trade is a good thing in itself, but there should be better ways of achieving this than through immiserising trade.) Immiserising trade expansion will not help Latin America cope with its debt.

Improving trade efficiency. The experience of immiserising trade expansion in the 1980s points to a failure to compete abroad in terms of nonprice factors such as product quality, marketing organization, supporting financial services, prompt delivery, etc. If the WHFTA can help to improve the nonprice efficiency of trading, this would be not its least-important benefit to LAC countries; technical assistance and other relevant support in this area would deserve high priority. Improved trade efficiency

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

6. See P. Sarkar and H. W. Singer, "Manufactured exports of developing countries and their terms of trade since 1965." *World Development, Vol 19,* No.4, pp. 333-340, 1991.

has in fact been put forward as a major argument in favor of an association of developing and industrial countries in a preferential or free-trade area:

> As the markets of the industrialized countries are the key markets for the nontraditional exports of the developing countries a preferential trade arrangement with these countries removes the uncertainty of export pessimism that often acts as a restraint in stimulating export production in the developing economies. Secondly, the markets of these countries may act as better "incubators" in assisting developing countries' producers to acquire the marketing experience in exports that they lack. The markets of the industrialized partners are likely to be sophisticated enough to act as useful "incubator markets" whilst the preferential arrangement offers them a breathing space by reducing the strength of international competition within the preferential trade area. One can recall the case of the preferential agreements of the EEC with a number of Mediterranean countries in agricultural products (both processed and unprocessed) to see the relevance of this point.[7]

How Should the Gap be Closed?

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

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

Modification of Adjustment Policies. The question previously raised concerning the nature of the connection between membership in WHFTA and adoption of free market policies can be sharpened by

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

8. See Donald Keesing and Andrew Singer, "Why official export promotion fails." *Finance and Development,* March 1992. However, this article underemphasizes the need for an active government role in trade promotion.

asking, "Will required adjustment policies be modified to allow for regional cooperation and the establishment of WHFTA as a 'genuine partnership' or will the WHFTA be constructed in such a way that it becomes an instrument to apply pressure for specific reform policies?" Negotiations will produce compromises and establish a middle ground between the extremes. These negotiations will necessarily extend over a number of years (perhaps, on historical precedent, five years after the U.S. presidential elections). During this time the external global environment, the situation in the U.S. and Latin America, as well as development thinking and the views of policy makers in both the North and South (and in the Bretton Woods institutions) may change. LAC countries are likely to want to preserve the option of pursuing active policies in key strategic areas, following the East Asian development model (both Japan during the relevant period and South Korea), and to some extent the continental Western European model. Such strategic policy intervention may be required in order to take full advantage of the new opportunities in the North American markets opening up under WHFTA.

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

The need for infrastructure. One may generally predict that countries with a larger domestic market, indigenous technological capacity, and good infrastructure for transportation, communication, etc., will be in a better position to derive advantage from a WHFTA than countries without these assets. The more advanced countries are more likely to benefit than the less advanced ones. The policy conclusion to be drawn is that the poorer countries deserve special consideration and perhaps compensation. The establishment of preconditions for seizing opportunities in the poorer countries (infrastructure, technology, information, etc.) should be assigned high priority in implementing the WHFTA.

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

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

Although the resources of the fund were very small in relation to the ambitious task the MIF was set to perform, the proposal to create such a fund to help the LAC countries meet the "indicators of readiness" was a significant initiative. The proposal recognized that an inflow of external resources is a necessary complement to internal reforms. In addition, the MIF initiative recognized that swift, successful adjustment in the investment sector in Latin America requires costly, one-time grant financing which the multilateral development banks are not equipped to provide, to be used for crucial technical assistance, to encourage the investment reform process, and to ease the burdens of adjustment. In the debt arena, the Congress has enacted separate authority which allows the president to reduce the so-called PL-480 program and U.S. Agency for International Development debt of least-developed countries that are moving toward market-oriented economies. In this direction, and in order to deal with debt issues in LAC countries, the Initiative proposed an Enterprise for the Americas Facility administered by the Treasury Department. Dept reduction, investment reform, and environmental protection were included in the package. The facility was designed to support debt reduction programs for countries that meet certain eligibility requirements:

(1) The country should have an IMF standby arrangement, an arrangement under the World Bank structural adjustment facility, or in exceptional circumstances, an IMF-monitored program or its equivalent.

(2) The country should be receiving structural or sectoral loans from the World Bank or the International Development Association.

(3) The country should have in place major investment reforms in conjunction with an IDB loan, or it should be implementing an open investment regime.

(4) The country should have negotiated a satisfactory financing program with commercial banks, including debt and debt-service relief (if appropriate).

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

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

When the above conditions are met, the U.S. would provide new payment terms for outstanding debt. The Initiative also provides for the reduction of a portion of assets held by the Commodity Credit Corporation (CCC) and a portion of Export-Import Bank loans, provided the eligible country confirms that debt relief assistance will be used to carry out debt-for-equity or debt-for-nature swaps.

Earlier in this paper it was stressed that free trade agreements based on negative integration measures can seldom be equally beneficial between partners with sharply disparate levels of per capita income and social conditions. The necessary "catching up" cannot happen without external resources and support, and without some degree of "catching up" LAC countries will not be able to take full advantage of the benefits of WHFTA and participate in a "genuine partnership" in the Western Hemisphere.

Focus on people. Apart from the impact on the poorer countries, there is the overall effect on poverty to be considered. This is a question not only of distribution of benefits between countries but also of income distribution within countries. According to World Bank estimates, the number of persons living below the poverty line in Latin America almost doubled between 1985 and 1989 to over 100 million, almost one quarter of the total population. This increase was both absolutely and relatively higher than in any other part of the world, even including sub-Saharan Africa (although the incidence of poverty at 25 percent is less than in Africa or South Asia, where it is around 50 percent). About 70 percent of Latin America's poor are listed as extremely poor and live below an even lower poverty line; this proportion is also as high as in sub-Saharan Africa and higher than in all other regions. The impact of expanded trade on both the rural and urban poor in Latin America deserves special consideration in any negotiations. The analysis of WHFTA should not concentrate solely on technical, financial, and economic feasibility and consequences, but should include its impact on people. The UNDP, with its human resource development experience, could offer useful assistance. One would also hope, in this context, that the movement toward a WHFTA will be accompanied by greater emphasis on the social impact of structural adjustment programs; considering the great influence of the U.S. on the policies of the IMF and the World Bank, this could legitimately be included in the WHFTA negotiations.

Problems of Negotiation

Indicators of Readiness

The EAI was broadly designed to support the new commitment of Latin American and Caribbean governments to democracy and market-oriented reforms through a program that would cut trade barriers, promote investment, and help reduce debt.

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

The United States has signed bilateral framework agreements with all LAC countries except Haiti, Surinam, and Cuba. The framework agreements were seen as a mechanism that enabled the United States and its prospective partners "to move forward on a step-by-step basis to eliminate counterproductive barriers to trade and investment, and establish a channel to advance the EAI vision."[9] Prospects for FTA talks depend on progress toward economic reform and political stability.

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

EAI entry rules remain an open issue, and no decision has been made about whether other countries could accede to the NAFTA or whether separate FTAs would be negotiated. However, the NAFTA treaty is still an important model for the countries of Latin America and the Caribbean regarding the rights and obligations that the U.S. will expect in trade pacts with LAC countries.

The sequencing of prospective FTA negotiations is still not clear, but a serious phase of new talks will soon begin. However, there are five possible scenarios for LAC countries:

(1) as LAC countries meet the preconditions, they negotiate bilateral FTA agreements with the U.S.;

(2) FTA agreements are reached between the U.S. and groups of subregionally integrated LAC countries;

(3) LAC countries join NAFTA;

(4) NAFTA is extended to include subregionally integrated LAC countries; or

(5) all LAC countries join NAFTA at the same time.

A complete WHFTA will materialize only if all Western Hemisphere countries enter into a free trade agreement with the United States and Canada. That can happen either simultaneously for all LAC countries if scenario 5 is followed, or step by step in a combination of scenarios 1-4.

The Role of Regional Groupings

It is not clear what the role of existing regional groupings in Latin America and the Caribbean will be in the coming WHFTA negotiations. Will the negotiations be with such regional associations as a single negotiating partner, or will they be with the individual members of such associations? The accession clause to NAFTA offers a route to a piecemeal, country-by-country movement from NAFTA

9. United States Department of Commerce, "Enterprise for the Americas," January 17, 1992.

to WHFTA that has been described as "minilateral." From the point of view of LAC countries, piecemeal accession carries a danger of zero-sum games, i.e., preferential treatment of one LAC country may displace trade of another LAC country that exports similar products to North America.

The relationship between WHFTA and existing or prospective regional groupings in Latin America such as ALADI, the Andean Pact, the Central American Common Market, CARICOM, and MERCOSUR, is clearly complex. In practice it will be difficult to avoid weakening these regional groupings as a result of WHFTA. The U.S. is, in principle, supporting regional cooperation within Latin America. This means that everybody wants to avoid bypassing or disrupting existing regional groupings through competition among individual member countries to enter into direct negotiations on WHFTA and compete for access to the U.S. market and the associated investment and debt packages. There is also a danger that any such bypassing of existing regional groupings in favor of direct negotiations may conflict with the provision common to all existing groupings that prohibit such bilateral treaties and provide that any tariff preference with a non-LAC country (which would include the U.S. and Canada) must automatically be fully extended to the other members of the regional grouping. The most realistic proposal in the circumstances seems to be that arrived at by SELA.[10] This suggests that the regional groupings should first define a common position concerning the "criteria, rules of the game, and issues to be considered"—perhaps leading to a common LAC position but leaving the detailed negotiations and conclusion of actual agreements to individual countries or subregional groupings. This is a suggestion to be carefully considered, although the distinction between "rules of the game" and an agenda for the negotiations on the one hand and the actual negotiations on the other may not be easy to maintain in the actual unfolding of events, as experience with the Uruguay Round and other GATT negotiations seems to suggest.

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

One major factor further complicating the negotiations is the fact that the major barriers to free trade between Latin and North America are not tariffs but nontariff barriers, which are much less transparent and much more difficult to negotiate. For example, U.S. nontariff barriers against imports from Latin America have been estimated, in terms of tariff equivalents, as 40 percent for sugar and

10. SELA, *The Enterprise for the Americas Initiative in the Context of Latin America and Caribbean Relations with the United States.* Consultation meeting on Latin America and the Caribbean relations with the United States of America, Caracas, April 2-24, 1991, SP/RC-IA/DT No. 2.

clothing, 30 percent for rice, 25 percent for dairy products, 20 percent for textiles, iron and steel, and color television sets (with much higher possible, e.g., 80 percent for sugar, 50 percent for textiles and clothing, etc).[11] These NTBs include voluntary export restraints, antidumping and countervailing duties, quotas, excise duties, etc., all of which may require different negotiating approaches and are also subjects of various kinds of multilateral negotiations. Multilateral liberalization would of course reduce the value of free trade access under WHFTA.

The inherent inequality in economic weight between North America and LAC suggests that from the LAC countries' point of view it is preferable to have as much as possible of the actual negotiations take place after they have defined a common regional position, whereas the U.S. might prefer to negotiate bilaterally or individually with the different subregional groups. Thus, the establishment of a proper framework for the negotiations acquires great substantive importance. The relationship between WHFTA and existing regional groupings in Latin America is a mirror image of the relationship between WHFTA and the MTS. In both cases the lesser level of cooperation—regional Latin American groupings in relation to WHFTA and WHFTA in relation to global trade liberalization—can be either a stepping stone or a stumbling block.

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

Lessons from the CUSFTA and NAFTA

Experience with the CUSFTA shows that even in the best of circumstances and with goodwill on both sides an FTA does not resolve all trade difficulties between the partners. The existence of current difficulties and tensions as well as their nature are instructive for LAC countries when they contemplate the coming WHFTA negotiations. The existence of difficulties years after the initiation of the CUSFTA and over a third of the way toward the benchmark of 1998 for the elimination of all customs tariffs demonstrates the great importance of an effective agreement on trade-dispute settlement. This will not be easy to reconcile with the implicit unilateralism of such U.S. trade legislation as Section 301 and claim to determine injury to domestic producers unilaterally rather than submit to GATT procedures or deal with disputes by negotiated treaty. (The problem may also apply in reverse if LAC countries wish to prevent injury to domestic producers from cheap U.S. imports.) To avoid future disappointments and friction, this matter should be clearly settled as part of the WHFTA negotiations. There are already precedents for the targeting of LAC countries by 301 and Super-301 actions by the U.S. Between 1980 and 1985, out of 252 countervailing duties initiated by the U.S., 51 (20 percent) were against Brazil and Mexico.[12] The CUSFTA experience and the NAFTA provide a hopeful model of dispute settlement on the basis of binational procedures that could be readily extended to WHFTA.

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11. See Erzan and Yeats, op. cit., p. 29.

12. Paolo Bifani, "International trade from the 1980s to the 1990s: the Latin American perspective," *IDS Bulletin*, January 1990, p. 80.

The nature of the tensions between the U.S. and Canada is also instructive in another sense. For example, consider the dispute over a ruling that automobiles assembled in Canada failed to meet the local-content requirement for duty-free access to the U.S. under the FTA. The definition of local content and the operation of rules of origin are notoriously thorny questions. In the case of the WHFTA, there will be the added problem of the extent to which origin will be determined on a purely national and bilateral basis (say, goods from Brazil admitted duty-free to the U.S. if they satisfy a requirement of 50 percent Brazilian origin) or on a hemispheric basis, say, Brazilian goods admitted duty-free as long as 50 percent or more originates in the Western Hemisphere. One would imagine that in the spirit of a WHFTA the latter would be the rule. The determination of rules of origin and local content would be especially important to LAC countries in a WHFTA since one of the main advantages of WHFTA to them would be the attraction of foreign investment from outside the hemisphere to take advantage both of lower wages and of free access to the North American market. Since many of these investments would have an assembly element and be based on global components, the determination of local origin becomes especially difficult and especially important.

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

BEYOND NAFTA:
EMPLOYMENT, GROWTH, AND INCOME-DISTRIBUTION EFFECTS
OF A WESTERN HEMISPHERE FREE TRADE AREA

Robert A. Blecker
William E. Spriggs

Introduction

Negotiations for a North American Free Trade Agreement (NAFTA) to link the United States, Mexico, and Canada had not even started when proposals for establishing a broader Western Hemisphere Free Trade Area (WHFTA) began to be heard. Former U.S. President George Bush quickly endorsed the idea with the Enterprise for the Americas Initiative (EAI). In practice, however, hemisphere-wide integration took a back seat while the negotiation of the NAFTA was under way.

In the meantime, there has been a far-reaching debate over the likely consequences of the NAFTA for the three member countries. In the course of this debate, it has frequently been observed that the NAFTA will largely extend and deepen a process of U.S.-Mexican economic integration that was already taking place. Mexico has made a phenomenal opening to foreign trade and investment in the previous five years, a reversal of 70 years of efforts to develop autonomously. Mexico has already acquired an unprecedented importance in U.S. foreign investment and in manufacturing employment generated by U.S. firms.

For this reason, even though precise predictions are difficult to make (and to believe), it is possible to infer how the NAFTA is likely to affect the United States and Mexican economies by extrapolating from the effects of the ongoing integration process between them.[1] Of course, it would be naive simply to project existing trends into the future, especially when both economies are undergoing profound structural changes. Nevertheless, we believe that any serious discussion of the NAFTA must begin with an appreciation of how U.S.-Mexican integration had already affected both nations' economies, rather than by making forecasts derived from theoretical models of trade liberalization.[2]

From this perspective, the best way to look at the NAFTA (at least for the United States and Mexico) is as *an opportunity to regulate and manage a process that is already going on* and which is probably impossible to stop altogether. The issue was not *whether* the U.S. and Mexico would become more tied together economically, but *how* they would be connected, and how the costs and benefits of integration would be distributed among different groups in those countries and, by extension, in Canada as well. Up to the present, the mobility of capital has already far outstripped the ability of labor organizations, local communities, or national governments to respond to the challenges that mobility poses. It is clear from the text of the NAFTA that its main intention is to

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1. It is somewhat harder to draw inferences about the likely effects of the NAFTA on Canada, since (as will be shown below) Canadian-Mexican trade is still minuscule. Since the present authors' concern is principally with the U.S. and Mexico, we will focus largely on those two countries.

2. See Stanford (1992) for a critique of theoretically based models of U.S.-Mexican trade liberalization and the NAFTA.

extend the *status quo* by giving greater protections and incentives to foreign investment in Mexico, with less protection for the environment and none for labor rights or standards.

This paper draws largely on what the authors learned from the debate in the United States, and to a lesser extent from the discussions in Mexico and Canada, about the probable effects of NAFTA, in order to offer some hypotheses about the probable effects of a Western Hemisphere Free Trade Agreement (WHFTA). While analysis of the NAFTA can proceed on the basis of ongoing trends, analysis of a WHFTA is impeded by the much lower degree of existing economic integration between the U.S. (or North America as a whole) and most of South America. Only in certain parts of Central America and the Caribbean does the existing economic integration with the U.S. resemble that with Mexico, and these regions are already part of a preferential trading arrangement with the U.S. under the Caribbean Basin Initiative (CBI).

Most of the nations of Latin America and the Caribbean (LAC) have increased their integration into the world trading system in the past decade. Most Latin American nations have reduced their trade and investment barriers since the debt crisis of the early 1980s. Trade and investment liberalization measures have been adopted as part of the "structural adjustment policies" promoted by the United States government along with the IMF, the World Bank, and other international organizations, in response to the perceived failure of past economic policies. But most of these liberalization measures have trade and capital flows with all nations—not just the United States. (Mexico's trade and investment liberalization in the late 1980s was also unilateral, but Mexico's proximity to the U.S. market led to a concentration of the new trade and investment flows in that direction.) In this respect, moving toward a WHFTA would be less of an extension of ongoing liberalization measures, and more of a shift from unilateral liberalization to preferential trade arrangements, for the nations of South America, as compared with Mexico or the Caribbean and Central American nations included in the CBI.[3] With regard to South America especially, therefore, it is necessary to adopt a comparative perspective in order to gain insights into the degree to which it would or would not follow the Mexican model after the formation of a WHFTA.

The rest of the paper will examine recent trends in United States-Mexican trade, employment, and investment relations as preparation for a comparative analysis of hemispheric integration. It will move from goods markets to labor markets to capital markets. Trends in economic development and trade relations among the different countries and regions of the western hemisphere are the topic of section two. Section three contains an analysis of the effects of the opening up of trade on employment, wages, and income distribution. Section four examines capital flows and macroeconomic relationships both in the western hemisphere and between it and other regions. In each case, the discussion starts from the more familiar territory of U.S.-Mexican relations and then assesses how well conclusions about those relations can be generalized and applied to other parts of the hemisphere. Finally, in section five the authors draw conclusions about policies for managing the process of hemispheric integration based on the concerns elaborated in the rest of the paper. The intention throughout is not to reach definitive conclusions but to raise questions that need to be dealt with by all who are seriously concerned about this process.

3. The authors are indebted to H. W. Singer for suggesting this point.

2. Goods Markets: Developmental Differences and Trade Flows

Basic Indicators of Development

This section begins by examining some standard "development indicators" for the United States, Canada, and Mexico, as well as totals for Latin America (including Mexico) and the Caribbean (LAC), shown in Table 1. Most striking are the differences between how these countries compare in terms of population versus income. Mexico has about one third the population of the U.S. (based on 1990 figures) and is projected to have nearly half the U.S. population by 2025; Latin America as a whole has three quarters more people than the U.S. today and is expected to have more than double the U.S. population by 2025. Yet Mexico has barely 4.4% of the GDP of the U.S., and all of Latin America combined has less than one fifth of the U.S. GDP. The per-capita income (GNP) of all Latin America is just one tenth of the U.S., and Mexico's is about one ninth that of the U.S.

These figures should prompt skepticism about the alleged enormous market that the NAFTA or the WHFTA would create for U.S. business. For example, it is often claimed that the NAFTA created a $6-trillion economy. But 96% of that economy already exists in the U.S.-Canada FTA, and 87% of it is in the U.S. alone; only 4% is gained by adding Mexico. With Mexico included, the three NAFTA countries had a total GDP of $6.2 trillion in 1990; without adding on Mexico, the U.S. and Canada together already had a combined GDP of $6.0 trillion. And most of the Mexican consumers who will be added on are much poorer than those of the U.S. and Canada. With per-capita income one ninth of the U.S. level, and greater inequality, the ability of the average Mexican family to purchase exported U.S. consumer goods must be quite minimal. The picture changes only slightly if we shift the focus to a WHFTA. The U.S. alone would constitute 77% of a WHFTA, and the U.S. and Canada together would make up 85%. The other 15 percent would be composed of Latin Americans who, while more numerous, are also much poorer on average than their North American cousins (and even, on average, poorer than most Mexicans).

It is difficult to see *a priori* how adding a relatively small and impoverished market could give the U.S. significant aggregate gains from trade, either static or dynamic, regardless of whether one assumes a model based on constant or increasing returns to scale. Of course, there could be large gains in specific sectors that have significant exports to Latin America (which could be expected to be mainly producer goods sectors), as well as large losses in specific sectors that compete with imports from Latin America.

At first glance, there appear to be enormous potential gains for Latin American countries from improved access to the vast United States-Canada consumer market. But the realization of that potential depends on many factors. Latin America's potential for export gains will depend heavily on the growth of the U.S. market in the next decade. The U.S. market's growth, fairly rapid in the 1980s, was largely fueled by unsustainable deficit spending and rising debt—much like that of Latin America in the 1970s. The 1990s are likely to be a decade of slower growth in the U.S. economy, given the sluggish recovery from the 1990-91 recession and the contractionary effects of President Clinton's initiatives for reducing the federal government's budget deficit. The question of the prospects for U.S. market growth will be revisited in section 4, below. It is worth mentioning here, however, that if the U.S. market does not grow rapidly, Latin American countries will gain only to the extent they can take market shares away from more efficient East Asian competitors. While the trade preferences under a WHFTA would help, this would still be difficult for many Latin American

Table 1
Basic Development Indicators for the United States,
Canada, Mexico, and LAC

	U.S.	Canada	Mexico	LAC
Population (millions)				
1990	250	27	86	433
2025 (projected)	307	32	142	699
Population growth, average annual percentage rate				
1980-1990	0.9%	1.0%	2.0%	2.1%
Projected, 1989-2000	0.8%	0.8%	1.8%	1.8%
Working-age population (15-64 years), in millions				
1990	165	18	51	275
Projected, 2025	188	19	97	441
Gross national product per capita, 1990, in U.S. dollars	21,790	20,470	2,490	2,180
Gross domestic product (GDP), 1990, in billions of U.S. dollars	5,392	570	238	1,015
Growth of GDP, average annual percentage				
1965-1980	2.7%	4.8%	6.5%	6.0%
1980-1990	3.4%	3.4%	1.0%	1.6%

Note: Data for LAC include Mexico.

Source: World Bank, *World Development Report 1992*, World Development Indicators (Tables 1, 2, 3, 5, and 26), and calculations of the authors.

countries to achieve, especially those that have not already distinguished themselves as competitive exporters of manufactured products.

While total products and per capita incomes are the most relevant indicators of likely gains from trade, population and demographic data are more important indicators of the opportunities for foreign direct investment (FDI) by multinational corporations (MNCs). Note especially that Mexico's working-age population (15-64 years) is projected nearly to double in the next 35 years (1990-2025), with an increase of 46 million workers over the existing 51 million. This is an increase of more than one million workers per year, and it means that the Mexican work force will leap from less than one third of the U.S. work force today to over half in just one generation.

Even the highest estimates of the employment-creation effects of the NAFTA for Mexico show that it would not suffice to absorb more than a small fraction of this projected increase in Mexico's labor force.[4] For the foreseeable future, then, the assumption of an infinitely elastic supply of labor at a relatively constant real wage is a reasonable first approximation for Mexico. This vast and ever-expanding source of cheap labor, and not the limited Mexican consumer market, is what excites American corporate capital about the prospects for a NAFTA. Basic economic reasoning suggests that giving American firms greater access to such a large and growing supply of labor cannot help but depress wages for American workers.[5] The numbers also suggest that, even if some Mexican workers get manufacturing jobs at the expense of U.S. workers, average Mexican real wages are unlikely to rise substantially for a long time to come—especially if Mexican workers have to compete with even lower-wage workers from other Latin American countries in a WHFTA. And finally, these numbers suggest that the NAFTA will hardly make a dent in the prospective influx of Mexican (or other Latin American) migrants to the U.S. in the next few decades. Taking account of these demographic trends, as well as the disruptions to peasant agriculture caused by the liberalization of agricultural trade,[6] the migration problem may well worsen rather than improve following the adoption of the NAFTA if it is not accompanied by domestic policies to deal with rising structural unemployment in Mexico.

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4. This conclusion is based on a survey of models which generally show favorable effects of the NAFTA on Mexican employment in the U.S. International Trade Commission (USITC), *Economy-Wide Modeling of the Economic Implications of a FTA with Mexico and a NAFTA with Canada and Mexico*, Report on Investigation No. 332-317, USITC Publication 2516, Washington, DC, May 1992. In this survey, the *highest* estimate of the increase in Mexican employment is a *once-and-for-all* gain of 6.6%, based on the Bachrach-Mizrahi (Policy Economics Group of KPMG Peat Marwick) model with additional capital invested in Mexico (none of which is assumed to displace capital which would have been invested in the U.S.). Since the Mexican labor force is projected to grow by 1.85% *per year* from 1990-2025, or 90% over a 35-year period, even this highly optimistic estimate would provide jobs for only a few years' net entrants into the Mexican labor force. Most of the estimates of the change in Mexican employment from the models surveyed by the USITC are much smaller. One other model (Sobarzo) implies employment gains in the range of 5.1 to 5.8%; the other estimates range from −0.9% over ten years in one version of Clopper Almon's model to +2.4% in one version of Roland-Holst et al. (of the USITC Research Staff). Almon's model is the only dynamic one; all the others are static.

5. On this point see the compelling analysis of Leamer (1992).

6. This problem has been emphasized in the studies by Levy and van Wijnbergen and by Robinson et al. in USITC (1992), as well as by Hinojosa-Ojeda and Robinson (1992).

Trade Trends

Table 2 shows data on the value, growth, and composition of merchandise trade for the United States, Canada, Mexico, and other LAC countries. The total value of Latin America's trade (exports plus imports) is approximately equal to that of Canada, a country with one sixteenth the population of Latin America (and just over half the GDP). Mexico's total trade is only about one fifth of Canada's. U.S. trade, nearly $900 billion, dwarfs that of the other countries.

In terms of growth rates, the most notable difference is that between the rapid growth of U.S. and Canadian imports in the 1980s and the *negative* growth of imports in both Mexico and Latin America as a whole during that decade. When we consider that these are growth rates of *nominal* import values, these negative growth rates are even more striking. The depression of Latin American demand in the 1980s, a result of rising interest rates, falling terms of trade, the debt crisis, and contractionary stabilization policies, clearly took a toll in reducing the continent's ability to import primary and manufactured goods.

It is striking that both Mexico and Latin America as a whole continue to rely on primary products for the majority of their export revenue. For all of Latin America, primary products account for two thirds (67%) of the value of exports, and excluding Mexico the primary product share of other Latin American countries is even higher (70%). While these figures for primary products include oil, the falling oil prices of the post-1982 period have demonstrated that oil is no exception to the traditional problems of volatile and sometimes falling terms of trade for primary commodity exports. Figure 1 shows that the terms of trade for non-oil commodity exports of developing countries declined over the past three decades (despite the temporary commodity price boom of the 1970s) and fell very sharply in the 1980s.[7] These declining terms of trade have hamstrung the development efforts of countries relying on such exports to relieve tight foreign exchange constraints, service their debts, and help finance their economic growth.

Most Latin American nations are hoping that a WHFTA would open the doors for them to develop more exports of manufactures following the East Asia model. But given the current pattern of trade and the compelling logic of comparative advantage, a WHFTA might instead reinforce the traditional specialization of some Latin American countries in primary products. Most likely, those nations that already have relatively well-developed and efficient manufacturing sectors (e.g., Mexico, Brazil, Costa Rica, and the Dominican Republic) will be induced to move further in that direction, while the other nations will find themselves squeezed out of manufacturing markets and relegated to greater dependency on agricultural and mineral exports.

7. See Sarkar (1986) on the falling commodity terms of trade.

Table 2
Value, Growth, and Composition of Merchandise Trade
for the United States, Canada, Mexico, and LAC

	U.S.	Canada	Mexico	LAC
Value of trade, 1990 ($ billion)				
Exports	371.5	125.1	26.7	123.2
Imports	515.6	115.9	28.1	101.1
Average annual growth rates, 1980-1990 (%)				
Exports	3.3	5.9	3.4	3.0
Imports	7.6	8.4	−1.1	−2.1
Composition of exports, 1990 (%)				
Machinery and transport equipment	47	37	25	11
Other manufactures	31	26	19	21
Primary products	22	37	56	67
Composition of imports, 1990 (%)				
Machinery and transport equipment	40	50	36	31
Other manufactures	36	33	37	35
Primary products	24	17	27	34

Note: Data for Latin America include Mexico.

Source: World Bank, *World Development Report 1992*, World Development Indicators (Tables 14 and 15), and calculations of the authors.

Table 3
U.S. Bilateral Merchandise Trade Balances With Latin America and Other Countries, 1980, 1985, 1990
(US$ million)

Country	*1980*	*1985*	*1990*
World	−36,178	−148,474	−123,914
EEC	18,873	−22,623	2,541
Japan	−12,183	−49,749	−44,485
Other Asia	−4,476	−32,580	−43,424
Canada	−6,604	−22,176	−10,821
Other Western Hemisphere	−170	−18,076	−13,223
Mexico	2,311	−5,757	−2,422
South America	2,127	−11,505	−13,063
Argentina	1,838	−446	−485
Bolivia	−17	19	−72
Brazil	352	−5,007	−3,524
Chile	795	−176	101
Colombia	409	12	−1,371
Ecuador	−89	−1,384	−867
Paraguay	24	74	251
Peru	−271	−656	−74
Uruguay	80	−510	−191
Venezuela	−994	−3,431	−6,831
Central America and the Caribbean	−4,608	−814	2,262
Costa Rica	93	−148	−113
Dominican Republic	−33	−289	−169
El Salvador	−171	33	301
Guatemala	88	−43	−114
Haiti	47	−10	122
Honduras	−99	−125	2
Jamaica	−114	112	333
Netherlands Antilles	−2,231	−408	89
Nicaragua	23	−8	53
Panama	346	208	616
Trinidad & Tobago	−1,774	−800	−646

Notes: Data for other Asia for 1980 include an estimate for Taiwan. Other western hemisphere includes all countries in the hemisphere except U.S. and Canada. Regional totals include countries not shown separately. South America excludes the Guyanas, which are included in Central America and Caribbean.

Source: International Monetary Fund, *Direction of Trade Statistics*, various years, and authors' calculations.

Table 4
U.S. Merchandise Exports to Latin America and Other Countries, 1980, 1985, and 1990

	Value ---- *(US$ millions)* ----			*Growth rates* ----- *(% increases)* -----			*Shares of U.S. total* ----- *(%)* -----		
Country	*1980*	*1985*	*1990*	*1980-85*	*1985-90*	*1980-90*	*1980*	*1985*	*1990*
World	220,781	213,146	393,106	-3.5%	84.4%	78.1%	100.0%	100.0%	100.0%
EEC	58,861	48,994	98,032	-16.8%	100.1%	66.5%	26.66%	22.99%	24.94%
Japan	20,790	22,631	48,585	8.9%	114.7%	133.7%	9.42%	10.62%	12.36%
Other Asia	28,781	28,639	60,774	-0.5%	112.2%	111.2%	13.04%	13.44%	15.46%
Canada	35,395	47,251	82,959	33.5%	75.6%	134.4%	16.03%	22.17%	21.10%
Other Western Hem.	38,745	31,020	53,960	-19.9%	74.0%	39.3%	17.55%	14.55%	13.73%
Mexico	15,146	13,635	28,375	-10.0%	108.1%	87.3%	6.86%	6.40%	7.22%
South America	17,149	10,780	15,106	-37.1%	40.1%	-11.9%	7.77%	5.06%	3.84%
Argentina	2,630	721	1,179	-72.6%	63.5%	-55.2%	1.19%	0.34%	0.30%
Bolivia	172	120	138	-30.2%	15.0%	-19.8%	0.08%	0.06%	0.04%
Brazil	4,352	3,140	5,062	-27.8%	61.2%	16.3%	1.97%	1.47%	1.29%
Chile	1,354	682	1,672	-49.6%	145.2%	23.5%	0.61%	0.32%	0.43%
Colombia	1,736	1,468	2,038	-15.4%	38.8%	17.4%	0.79%	0.69%	0.52%
Ecuador	864	591	680	-31.6%	15.1%	-21.3%	0.39%	0.28%	0.17%
Paraguay	109	99	307	-9.2%	210.1%	181.7%	0.05%	0.05%	0.08%
Peru	1,172	496	778	-57.7%	56.9%	-33.6%	0.53%	0.23%	0.20%
Uruguay	183	64	145	-65.0%	126.6%	-20.8%	0.08%	0.03%	0.04%
Venezuela	4,577	3,399	3,107	-25.7%	-8.6%	-32.1%	2.07%	1.59%	0.79%
Central America and the Caribbean	6,450	6,605	10,479	2.4%	58.7%	62.5%	2.92%	3.10%	2.67%
Costa Rica	498	422	992	-15.3%	135.1%	99.2%	0.23%	0.20%	0.25%
Dominican Republic	795	742	1,658	-6.7%	123.5%	108.6%	0.36%	0.35%	0.42%
El Salvador	273	446	556	63.4%	24.7%	103.7%	0.12%	0.21%	0.14%
Guatemala	553	405	759	-26.8%	87.4%	37.3%	0.25%	0.19%	0.19%
Haiti	311	396	478	27.3%	20.7%	53.7%	0.14%	0.19%	0.12%
Honduras	376	308	563	-18.1%	82.8%	49.7%	0.17%	0.14%	0.14%
Jamaica	305	404	944	32.5%	133.7%	209.5%	0.14%	0.19%	0.24%
Netherlands Antilles	449	428	542	-4.7%	26.6%	20.7%	0.20%	0.20%	0.14%
Nicaragua	250	42	68	-83.2%	61.9%	-72.8%	0.11%	0.02%	0.02%
Panama	699	675	867	-3.4%	28.4%	24.0%	0.32%	0.32%	0.22%
Trinidad	680	504	430	-25.9%	-14.7%	-36.8%	0.31%	0.24%	0.11%

Notes: See Table 3 for notes on country definitions.

Source: International Monetary Fund, *Direction of Trade Statistics*, various years, and authors' calculations.

Table 5
U.S. Merchandise Imports from Latin America and Other Countries, 1980, 1985, and 1990

Country	Value — (US$ million) — 1980	1985	1990	Growth — (percentage increases) — 1980-85	1985-90	1980-90	Shares of U.S. total (percent) 1980	1985	1990
World	256,959	361,620	517,020	40.7%	43.0%	101.2%	100.00%	100.00%	100.00%
EEC	39,988	71,617	95,491	79.1%	33.3%	138.8%	15.56%	19.80%	18.47%
Japan	32,973	72,380	93,070	119.5%	28.6%	182.3%	12.83%	20.02%	18.00%
Other Asia	33,257	61,219	104,198	84.1%	70.2%	213.3%	12.94%	16.93%	20.15%
Canada	41,999	69,427	93,780	65.3%	35.1%	123.3%	16.34%	19.20%	18.14%
Other Western Hemisphere	38,915	49,096	67,183	26.2%	36.8%	72.6%	15.14%	13.58%	12.99%
Mexico	12,835	19,392	30,797	51.1%	58.8%	139.9%	4.99%	5.36%	5.96%
South America	15,022	22,285	28,169	48.3%	26.4%	87.5%	5.85%	6.16%	5.45%
Argentina	792	1,167	1,664	47.3%	42.6%	110.1%	0.31%	0.32%	0.32%
Bolivia	189	101	210	-46.6%	107.9%	11.1%	0.07%	0.03%	0.04%
Brazil	4,000	8,147	8,586	103.7%	5.4%	114.7%	1.56%	2.25%	1.66%
Chile	559	858	1,571	53.5%	83.1%	181.0%	0.22%	0.24%	0.30%
Colombia	1,327	1,456	3,409	9.7%	134.1%	156.9%	0.52%	0.40%	0.66%
Ecuador	953	1,975	1,547	107.2%	-21.7%	62.3%	0.37%	0.55%	0.30%
Paraguay	85	25	56	-70.6%	124.0%	-34.1%	0.03%	0.01%	0.01%
Peru	1,443	1,152	852	-20.2%	-26.0%	-41.0%	0.56%	0.32%	0.16%
Uruguay	103	574	336	457.3%	-41.5%	226.2%	0.04%	0.16%	0.06%
Venezuela	5,571	6,830	9,938	22.6%	45.5%	78.4%	2.17%	1.89%	1.92%
Central America and the Caribbean	11,058	7,419	8,217	-32.9%	10.8%	-25.7%	4.30%	2.05%	1.59%
Costa Rica	405	570	1,105	40.7%	93.9%	172.8%	0.16%	0.16%	0.21%
Dominican Rep.	828	1,031	1,827	24.5%	77.2%	120.7%	0.32%	0.29%	0.35%
El Salvador	444	413	255	-7.0%	-38.3%	-42.6%	0.17%	0.11%	0.05%
Guatemala	465	448	873	-3.7%	94.9%	87.7%	0.18%	0.12%	0.17%
Haiti	264	406	356	53.8%	-12.3%	34.8%	0.10%	0.11%	0.07%
Honduras	475	433	561	-8.8%	29.6%	18.1%	0.18%	0.12%	0.11%
Jamaica	419	292	611	-30.3%	109.2%	45.8%	0.16%	0.08%	0.12%
Neth. Antilles	2,680	836	453	-68.8%	-45.8%	-83.1%	1.04%	0.23%	0.09%
Nicaragua	227	50	15	-78.0%	-70.0%	-93.4%	0.09%	0.01%	0.00%
Panama	353	467	251	32.3%	-46.3%	-28.9%	0.14%	0.13%	0.05%
Trinidad	2,454	1,304	1,076	-46.9%	-17.5%	-56.2%	0.96%	0.36%	0.21%

Note: See Table 3 for notes on country definitions.

Source: International Monetary Fund, *Direction of Trade Statistics*, various years, and authors' calculations.

Trends in U.S. Bilateral Trade

The next three tables provide perspective on the United States' bilateral trade with the countries of the Western Hemisphere in comparison with its trade with the rest of the world. Table 3 shows U.S. bilateral trade balances for 1980, 1985, and 1990.[8] From 1980 to 1990, the U.S. trade deficit with the entire world widened from $36.2 billion to $123.9 billion.[9] Most of that increase was accounted for by larger deficits with Japan and other Asian countries (principally South Korea, Taiwan, and China), as well as by a reduced surplus with the European Economic Community (EEC). However, the U.S. trade balance with the Western Hemisphere also worsened by about $17 billion, $4 billion with Canada and $13 billion with Latin America.[10] The worsening of the U.S. trade balance with Latin America from 1980 to 1990 was more than accounted for by a $15 billion decline with South America, and a $5 billion negative swing with Mexico (this has since been reversed[11]), while the balance with Central America and the Caribbean improved by about $6 billion (about half of which is due to cheaper oil imports from Trinidad and Tobago and the Netherlands Antilles).

Table 4 shows the corresponding trends in the value of United States merchandise exports (in current or nominal dollars). The total value of U.S. exports *fell* by 3.5% from 1980 to 1985,[12] but then shot up by 84.4% from 1985 to 1990 for a gain of 78.1% over the decade. U.S. exports to Japan and the rest of Asia grew at notably above-average rates, while exports to Europe grew at less than average rates. In the Western Hemisphere, exports to Canada also grew at a rate that was significantly above average. Growth of exports to Mexico was only slightly above average over the decade, but in the 1985-90 period growth was almost as fast as exports to Japan and the rest of Asia.[13] Exports to all of Latin America (Latin America is shown as other Western Hemisphere including Mexico) grew by only 39% over the decade, and exports to South America (excluding the Guyanas) actually *fell* by nearly 12% between 1980 and 1990.

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8. The U.S. trade balance improved somewhat in 1991, mostly as a result of the country's economic recession and the falling value of the dollar (see Blecker, 1991b).

9. These data are taken from the International Monetary Fund, *Direction of Trade Statistics*, various years. This source shows a notably larger deficit for the U.S. in 1990 than some U.S. government sources show. On a balance of payments basis, the U.S. merchandise trade deficit as reported by the Department of Commerce, Bureau of Economic Analysis, was only $108.9 billion for 1990 (revised as of June 1992). However, on a Census basis, exports (f.a.s.) less imports (c.i.f.) was -$123.4 billion in 1990. The IMF data are closer to a Census basis.

10. In this context, "Latin America" refers to all western hemisphere nations other than the U.S. or Canada.

11. By 1992, the U.S. had a merchandise trade surplus with Mexico of $5.4 billion (according to the U.S. Department of Commerce, Census Bureau, "U.S. Merchandise Trade: December 1992," released on February 18, 1992). This remarkable shift was due partly to the large capital outflows to Mexico, partly to the growing overvaluation of the peso, and partly to the U.S. recession.

12. This and all other growth rates in Tables 4 and 5 are total rates for the periods shown, *not* average annual rates.

13. Since 1991, U.S. exports to Mexico have been one of the fastest growing parts of U.S. trade.

The relatively slow growth of U.S. exports to most of Latin America also shows up in a reduced Latin American share of U.S. exports (last three columns of Table 4). The total Latin American share fell from 17.6% in 1980 to 13.7% in 1990. While the Mexican share (including components for assembly operations) rose slightly, from 6.9% to 7.2%, the share of South America was more than halved, from 7.8% to 3.8%. Meanwhile, the shares of Canada, Japan, and other Asian countries rose sharply.

Table 5 shows changes in United States imports between 1980 and 1990. The total value of United States imports from the entire world increased by 101.2%. Imports from Asia roughly tripled, however, with increases of 182.3% from Japan and 213.3% from the rest of Asia. Aside from Uruguay, whose exports to the U.S. were minuscule to begin with, the only Latin American country whose sales to the U.S. increased at an Asia-like rate was Chile. U.S. imports from Chile grew by 181.0%, almost the same rate as from Japan. Other Latin American countries with relatively rapid growth of sales in the U.S. included Costa Rica (172.8% growth), Colombia (156.9%), and Mexico (139.9%), with Argentina and Brazil just behind. U.S. imports from Latin America as a whole grew by less than three quarters of the average rate for all countries (72.6%). These figures make it clear why many Latin American nations might view a FTA as essential for increasing their access to the U.S. market. Only by a preferential trading arrangement can most Latin American countries hope to restore the shares of U.S. imports they had a decade ago.

From the perspective of the United States, these figures show that there is also a tremendous range in the degree to which Latin American countries are poised to take advantage of an opportunity to penetrate the U.S. market. Beyond Mexico, a few Latin American countries (especially Chile, Colombia, and Costa Rica) have had outstanding success in exporting to the U.S. in the past decade.

Trends in Multilateral Trade

Consideration now shifts to the broader multilateral perspective of Western Hemisphere countries' trade with each other and with the rest of the world. Table 6 shows the shares of the exports of the United States, Canada, Mexico, and the rest of Latin America going to various countries and regions as of 1990. The data in this table show striking differences in the regional composition of trade in different parts of the Western Hemisphere. Both Canada and Mexico send about 73% of their exports (by value) to the U.S. Their interest in free access to the U.S. market is clear. But other Latin American countries excluding Mexico sell on average only about 31% of their exports to the U.S. The EEC's share is not far behind: 26%.

These average percentages conceal important differences among the other Latin American countries, especially between the nations of Central America and the Caribbean, which do export a lot to the United States, and many South American countries (notably Argentina, Brazil, Peru, and Chile) whose exports are more oriented toward Europe. Clearly, the current trade orientation of many of these Latin American countries does not suggest that they place a high priority on forming a trading bloc with the U.S. and Canada. For many of these countries, the WHFTA option seems to be of interest mainly because other avenues that might be superior—especially greater access to all industrial country markets via multilateral GATT negotiations or increased trade through regional Latin American FTAs—seem to be blocked. There is also the fear of losing out as a result of trade and investment diversion in Europe, through the strengthening of the European Community (EC), and in North America, due to the NAFTA.

Table 6 shows that intra-Latin American trade is only a small percentage of the region's total. Trade between Mexico and the rest of Latin America is almost negligible, just 5% of Mexican exports and barely 1% of other Latin American exports. Excluding Mexico, the other nations of Latin America conduct, on average, only 16% of their trade with each other, although they do send an average of 50% of their exports to the entire Western Hemisphere. And Latin America is far from the most important export market for the United States. It accounts for just under 14% of U.S. exports, about evenly divided between Mexico and the rest of Latin America. In contrast, Canada accounts for 21%, and the EEC for about 25%.

The intra- and interregional trade flows described by these data are uneven and asymmetric. In particular, Canada, Mexico, and the rest of Latin America are all far more dependent on trade with the United States than vice-versa. While this demonstrates the economic importance that FTAs with the U.S. can have for those countries, it should also give Canadians, Mexicans, and other Latin Americans pause to consider how much political bargaining leverage they can expect to have within a NAFTA or WHFTA. This should be of special concern to the smaller Latin American and Caribbean nations that do not have enjoy the leverage of a Mexico, Chile, or Brazil.[14]

Conclusion on Trade and Development Issues

Considering the huge asymmetries and divergences in both levels of development and in trade flows, the purely commercial rationale for a WHFTA seems weak for many countries in the hemisphere, especially in South America. Extending the NAFTA framework to embrace the rest of the Western Hemisphere would bring together a group of countries with disparate domestic structures and diverse patterns of trade. Some of the most important South American countries (such as Argentina, Brazil, Chile, and Peru) conduct most of their export trade with nations outside the Western Hemisphere[15] and sell more of their exports to the EC than to the U.S. Many Caribbean and Central American countries have proportionally more of their trade with the United States, but they already have preferential access to the U.S. market via the CBI.

These anomalies raise the question why there is so much interest in a WHFTA. Part of the answer lies more in the political realm than in the economic. The EC seems to be turning inward, not only in regard to trade but also in terms of investment flows, which are going increasingly to low-wage regions within Europe.

14. Similar considerations lead H. W. Singer to support a collective approach of Latin American countries to negotiating a WHFTA, in his contribution to this publication.

15. Exports to the entire western hemisphere, including the U.S., Canada, and all other countries, are only 40.7% of total exports for Argentina, 37.3% for Brazil, 31.1% for Chile, and 29.7% for Peru, as of 1990 (calculated from data in IMF, *Direction of Trade Statistics*, 1991 Yearbook).

Table 6
Shares of Merchandise Exports from the United States, Canada, Latin America, and Mexico to Selected Destination Countries, 1990
(percent)

Exports to:	Exports From: United States	Canada	Latin America[a]	Mexico	Other Latin America[b]
World	100.00	100.00	100.00	100.00	100.00
Industrial countries[c]	63.89	87.81	73.48	91.75	68.00
USA	0.00	72.66	40.44	73.12	30.64
Canada	21.10	0.00	2.18	2.42	2.11
Japan	12.36	5.44	5.89	5.37	6.05
EEC	24.94	7.59	22.64	10.16	26.38
Developing countries	35.05	7.63	24.14	7.56	29.11
Latin America[a]	13.73	1.57	14.51	5.40	17.24
Mexico	7.22	0.37	0.81	0.00	1.06
Other Latin America[b]	6.51	1.20	13.70	5.40	16.18
Other developing countries[d]	21.32	6.06	9.63	2.16	11.87
Total Western Hemisphere[e]	34.83	74.24	57.13	80.94	49.99
Total for countries shown[f]	98.94	95.44	97.62	99.31	97.11

Notes:
a. Includes all countries in the western hemisphere except United States and Canada.
b. Includes all countries in the western hemisphere except United States, Canada, and Mexico.
c. Includes countries not shown separately.
d. Developing countries excluding Latin America (as defined in note a).
e. Total for the hemisphere, including United States, Canada, Mexico, and all of Latin America.
f. Does not add to 100.00 percent due to the exclusion of the former U.S.S.R. and certain other formerly Communist countries.

Source: International Monetary Fund, *Direction of Trade Statistics,* 1991 Yearbook; and authors' calculations.

What would be the consequences for trade flows if a WHFTA were actually formed later in this decade? A few hypotheses may be ventured. One is that the growth of export-oriented manufactures will continue to be concentrated in limited parts of Latin America, especially Mexico, certain Central American and Caribbean countries, and the more industrially advanced South American nations such as Brazil and Argentina. Many of the poorest Latin American nations, especially in Central America and the Andean region, will find their high degree of specialization in primary product exports reinforced. Latin Americans who hope to follow the path of the prosperous East Asian NICs should remember that Korea, Taiwan, et al. achieved their stunning successes in export-oriented industrial development with significant government intervention and the strategic use of trade protection, not through deregulated "free markets" or complete trade liberalization (Amsden 1989, Smith 1991, Wade 1990).

While all the nations of Latin America could potentially attract more foreign investment in low-wage, labor-intensive manufactures, not all are likely to succeed. The economies of scale and scope that arise from investing in a small number of countries will tend to keep such investment concentrated largely where it is currently going. Moreover, Mexico and the Caribbean countries have natural advantages in access to the U.S. market as a result of geographical proximity and relatively low transportation costs. All of these are obstacles that nations such as Ecuador, Bolivia, or Paraguay will find difficult to overcome. Competing on the basis of who can offer the lowest wages and least protection of workers' rights and environmental safeguards is not a beneficial game to play.

Foreign investment in the countries that are specialized in primary products would undoubtedly increase under a WHFTA, but that investment would most likely flow to traditional mineral and agricultural areas. At best, some of the poorer Andean countries could hope to emulate Chile by moving into nontraditional primary products such as winter fruits and vegetables for the U.S. market—but even there they will face stiff competition from Mexico as well as Chile. More countries trying to sell the same products in the same market at the same time is a sure way to depress the commodity terms of trade rather than to boost economic development.

There is one positive commercial scenario that seems possible for the parts of Latin America that have relatively little to gain from access to North American markets. Although the initial attraction of the WHFTA concept is mainly to secure freer access to the United States market, a WHFTA would result in "plurilateral" trade liberalization across Latin America. Nations that are disappointed in the growth of their exports to the U.S. under a WHFTA could try to reorient their trade toward other Latin American countries. There are pitfalls here too, due to (1) the fact that most of the poorer Latin American countries tend to export products that are substitutes rather than complements (especially agricultural commodities), and (2) the risk that the smaller Latin American nations will be overwhelmed with manufactured exports from the larger nations such as Brazil, thus stifling domestic manufacturing development. These are the same difficulties that have contributed to the failure of most efforts at forming effective trading blocs within Latin America or its subregions.

3. Labor and Income Distribution

Current discussions of the potential impact of the NAFTA and WHFTA have concentrated on trade flows. As the previous discussion has shown, a WHFTA would have ambiguous effects on hemispheric trade patterns, but there are clear incentives for industrial capital to relocate investment in countries with abundant labor and low wages provided that productivity and quality can be maintained. These considerations suggest a shift in attention to investment flows and their effects on labor.

Most recent analyses of the effects of the NAFTA on labor have not been grounded in empirical studies of the North American labor market and have de-emphasized the role of investment flows within the continent.[16] Despite the evidence from the U.S.-Canada FTA, and from the recent opening of the Mexican market and its change in investment laws, economic modelers' guesses about the future dominated the debates over the effects of the NAFTA, and insufficient attention has been paid to the empirical evidence of the actual trends during the current integration of the North American market.

In part, the economic theorists excuse themselves from discussing the impact of foreign investment by assuming that products made in different countries, even if they bear the same label, are differentiated by consumers. This makes trade between countries more important than the location of production of MNCs. To assume that U.S. consumers differentiate between a Zenith television or Smith-Corona typewriter made in Mexico or in the U.S. is insupportable.

Unconstrained by the existing evidence, modelers have been free to make assumptions about the future that ignore the facts of the North American labor market. Most of the models start and end with the theoretical construct of comparative advantage—a "win-win" scenario. With two of the assumptions required to make trade advantageous to countries—full employment and balanced trade—the models constrain countries to specialize in the products they are comparatively most efficient at producing.

The full employment assumption ignores the past 20 years of poor performance by the U.S. labor market. Average real wages of U.S. workers of most education levels except postgraduate have fallen. The weakness of the U.S. labor market has made U.S. workers skeptical of economic models that assume the labor market to be in equilibrium and declare U.S. workers to be on a path to higher-wages. This paper concentrates instead on the actual pattern of employment creation and wage changes in the U.S. economy without the assumption of full employment. The focus of this section is particularly on the empirical evidence of the last six years, during which Mexico lowered its tariffs and lifted major restrictions on foreign direct investment, and the U.S. and Canada entered a FTA.

Table 7 shows the flow of goods between the United States, Mexico, and Canada, and the flow of goods among U.S.-owned affiliates operating in Canada and Mexico. Looking at all North American trade, 42% ($93.18/220.75) can be accounted for by the movement of goods among U.S.-owned affiliates operating in Canada and Mexico. Of course, much of the trade by U.S. multinationals is in the U.S.-Canada free trade area. Still, of the almost $25 billion that the U.S. exports to Mexico, $7.6 billion are shipments to U.S. multinationals operating in Mexico—roughly 30 percent of U.S. "exports." A similar proportion of U.S. imports are from U.S. multinationals

16. The best summary of the models and their prediction of the impact on labor is by Stanford (1993). A more suspect summary is by Hinojosa-Ojeda and Robinson (1992), who assume that the U.S. faces a serious shortfall in labor supply well into the next century. This, they proclaim creates a labor market complementarity between the U.S. and Mexico, because of Mexico's labor surplus. But Mishel and Texeira (1991) have shown that an honest evaluation of U.S. labor market indicators does not show any sign of a labor shortage developing.

operating in Mexico. This may seem a small figure when compared to U.S. multinationals and their activities in other countries, but because of past investment restrictions in Mexico, U.S. firms in Mexico are highly concentrated in manufacturing and virtually absent in primary products. The previous section noted that over half of Mexico's exports are in primary products. In that context, the involvement of U.S. firms is not small. Regardless, a large and growing portion of U.S.-Mexican "trade" is less about the shipment of goods based on comparative advantages, and more about the decision where to produce an item based on minimizing unit labor costs. In order to assess the impact of a FTA, therefore, it is necessary to model the behavior of U.S. multinational firms.

Table 8 shows the potential impact of decisions of United States MNCs on production workers in North America. The table compares employment by U.S. multinationals with domestic U.S. employment. it shows U.S. multinational affiliate employment in Canada and Mexico compared to total employment in the U.S. to capture all the sources of job creation and job loss at home including national firms (those with no foreign affiliates) and foreign firms with affiliates in the U.S. as well as the "parents" of U.S. multinationals. The absolute level of multinational affiliate employment appears small compared to the total for all U.S. manufacturing, but the changes in these levels and the trend of those changes over the last few years are of great interest.

Although all the absolute figures for Mexico in Table 8 may appear relatively small, in fact the *annual changes* in U.S. MNC employment in Mexico are large enough to have a substantial impact on the U.S. labor market. The number of workers at MNC affiliates in Mexico rose from 370,200 in 1986 to 462,500 in 1990, an increase of 92,300 or 24.9%. The total number of U.S. domestic manufacturing production workers was much larger to start with, about 12.9 million in 1986. This number increased by 392,000 (3%) from 1986 to 1989, and then fell by 295,000 from 1989 to 1990, for a total increase of only 97,000 (0.8%). Thus, at the margin, the number of jobs created by U.S. multinational affiliates in Mexico is comparable in magnitude to the number of jobs created in the U.S. domestic manufacturing sector in recent years. The claims that Mexico is too small to have an appreciable effect on the U.S. manufacturing work force are therefore not credible.

In fact, the type of comparison made in Table 8 actually understates the extent to which changes in the North American labor market reflect shifts away from employment in the United States and Canada. This is because only the actions of U.S. multinational affiliates are considered when looking at Canada and Mexico, while all firms are included in the U.S. domestic figures. Thus, for example, the data do not include jobs created by Japanese or European firms in Mexican manufacturing. The data may also undercount U.S. multinationals' true employment in Mexico. Some U.S. corporations have used "shell" operations to limit the risk of outright ownership of a Mexican plant. These shell operations still result in increased employment in Mexico under their control (Sinkin 1990).

In 1986, Canadian workers at U.S. multinationals represented 24.1% (472.7/1,959)[17] of Canadian manufacturing workers. Despite the importance of U.S. multinationals to the Canadian labor market, the decline in Canadian workers in U.S. firms from 1988 to 1989 is offset by a net increase in total Canadian manufacturing employment. From 1988 to 1989, Canadian manufacturing employment increased 0.9%, from 2.072 million to 2.09 million. It also must be remembered that a

17. ECD, *Labour Force Statistics 1969-1989* (1991). Pages 84-85.

Table 7
North American Trade, 1989
All Trade and Trade by U.S. Foreign Affiliates
Operating in Mexico and Canada
($ billion)

	All exports from			Exports from U.S. multinationals located in		
Exports to	U.S.	Canada	Mexico	U.S.	Canada	Mexico
U.S.	...	87.95	27.16	...	40.14	7.27
Canada	78.81	...	1.43	38.18	...	...
Mexico	24.98	.52	...	7.59	...	...
Totals	103.79	88.37	28.59	45.77	40.14	7.27

Source: U.S. Dept. of Commerce, *Survey of Current Business*, Vol. 71 (October, 1991): Table 19, page 51 and S-16, S-17 for all U.S. trade; IMF, *Direction of Trade Statistics, Yearbook 1991*, page 156 for Canada-Mexico trade statistics; and authors' calculations.

decline in employment with U.S. firms is not necessarily a decline in employment in Canada. The sale of a U.S. affiliate could leave Canadian employment constant but decrease Canadian employment in U.S. affiliates. And, while the table includes employment growth for U.S. workers resulting from direct foreign investment in the U.S., the table ignores gains that Canadians may have realized from direct foreign investment from countries other than the United States.

These shifts in the location of employment by United States firms should be interpreted carefully. The fact that U.S. firms hired as many Mexican manufacturing workers as Canadian by 1990 does not necessarily mean that U.S. firms are part of the cause of the downturn in the Canadian labor market. But the fact that U.S. firms in 1990 were still increasing their employment in Mexico while cutting employment in the U.S. and Canada may be contributing to the slow recovery in employment in the U.S. after the recent recession. Further, should that pattern continue, U.S. and Canadian manufacturing employment may not return to their prerecession levels. The point that U.S. firms created almost as many net new manufacturing jobs in Mexico as in the U.S. between 1986 and 1990 does not necessarily imply that these shifts are a cause of the downturn in the U.S. market. However, the data do suggest that such shifts may be part of the explanation for the slow recovery of manufacturing jobs since the 1990-91 recession.

Supporters of the NAFTA often argued that changes in total jobs are unimportant, and only the sectoral reallocation of employment matters. They admitted that the NAFTA will cause some loss of low-wage jobs in the U.S. but claimed that this will only free up American workers to enter more highly paid jobs in other sectors. In fact, about three quarters of the manufacturing jobs created in Mexico by U.S. firms in the last several years have been in just two sectors: transportation equipment (especially automobiles and parts), and electronics. Manufacture of automobiles is a highly capital-intensive industry with above-average wages, while electronics is a "high-tech" industry

Table 8
Employment of Manufacturing Production Workers in North America, at U.S. Multinational Affiliates in Mexico and Canada, and Domestic Manufacturing Production Workers in the U.S., 1986-1990

	Numbers of workers ('000)			Annual change in number of workers (1,000s)		
	U.S. MNC affiliates		Total domestic U.S.	U.S. MNC affiliates		Total domestic U.S.
	In Canada	In Mexico		In Canada	In Mexico	
1986	472.7	370.2	12,877.0	...	...	...
1987	469.7	377.0	12,970.0	−3.0	6.8	93.0
1988	483.0	397.4	13,221.0	13.3	20.4	251.0
1989*	475.6	443.5	13,269.0	−7.4	46.1	48.0
1990	452.0	462.5	12,974.0	−21.1	18.5	−295.0
	Percent Change			Total Change		
1986-1989	0.6%	19.8%	3.0%	2.9	73.3	392.0
1986-1990	−4.4	24.9	0.8	−20.7	92.3	97.0

* There is a break in employment data from 1988 to 1989 caused by the Benchmark Survey taken in 1989 that was more inclusive than for the annual data used in 1988. In the aggregate, the benchmark caused a net decline of 46.3 thousand workers in all U.S. affiliates--worldwide, and regardless of industrial sector. This is because there were more losses from affiliates leaving the survey, than gains from affiliates being added to the survey. However, there was a net gain in employment among affiliates through an increase in affiliates and an increase in employment in affiliates that operated in both 1988 and 1989. The effect of the benchmark is only for the year to year comparison from 1988 to 1989, and data before 1989 with 1989 and later. The net change in worldwide U.S. affiliate employment represents 17.5 percent of the gross change in worldwide affiliate employment. The effect for individual countries may vary. A revision of the data is forthcoming possibly in 1993.

Source: U.S. Dept. of Commerce, *Survey of Current Business*, Vol. 72 (August, 1992): Table 13.1 and Table 13.2, pages 77-78; Vol. 71 (October, 1991): Table 20.1 and Table 20.2, pages 52-53; Vol. 70 (June, 1990): Table 6, page 37; Vol. 69 (June, 1989): Table 7, page 33 for employment by U.S. multinationals in Canada and Mexico; U.S. Dept. of Labor, Bureau of Labor Statistics, *Hours, and Earnings, United States, 1909-90, Volume 1*, Bulletin 2370 (March, 1991), page 61, *Supplement to Employment, Hours, and Earnings, United States, 1909-90* (July, 1991), page 11, and authors' calculations. Numbers for U.S. affiliates' employment in Canada and Mexico is for all manufacturing workers. Employment in the U.S. is for production workers only. Employment in the U.S. includes all U.S. firms including U.S. multinationals, domestic U.S. and foreign direct investors in the U.S.

Table 9
U.S. Multinationals and U.S. Domestic Employment
Manufacturing Production Workers in Selected Industries in Mexico and the U.S.,
(Thousands of workers, 1986-1990)

	Mexican Employment in Nonbank U.S. Affiliates in Selected Industries		U.S. Domestic Employment of Production Workers in Selected Industries		
	Electric & Electronic	Transportation Equipment	Electric & Electronic	Transportation Equipment	Motor Vehicles & Equipment
1986	77.2	71.8	1,184.2*	1,258.6	670.7
1987	83.2	73.3	1,175.2*	1,279.0	673.7
1988	98.6	84.1	1,113.7	1,274.2	668.3
1989	110.6	92.5	1,103.9	1,279.3	664.9
1990	116.5	102.6	1,055.4	1,218.3	615.2
	Absolute Change		Absolute Change		
1986-1989	33.4	20.7	−80.3	20.7	−5.8
1986-1990	39.3	30.8	−128.8	−40.3	−55.5
	Percent Change		Percent Change		
1986-1989	43.3%	28.8%	−6.8%	1.6%	−0.9%
1986-1990	50.9	42.9	−10.9	−3.2	−8.3

* For 1986 and 1987 these are the sum of production workers in the 1989 two digit code 36, i.e. SIC 361-369.

Source: U.S. Dept. of Commerce, Survey of Current Business, Vol. 72 (August, 1992): Table 13.1 and Table 13.2, pages 77-78; Vol. 71 (October, 1991): Table 20.1 and Table 20.2, pages 52-53; Vol. 70 (June, 1990): Table 6, page 37; Vol. 69 (June, 1989): Table 7, page 33 for employment by U.S. multinationals in Mexico; U.S. Dept. of Labor, Bureau of Labor Statistics, Hours, and Earnings, United States, 1909-90, Volume 1, Bulletin 2370 (March, 1991) pages 61, 290, 329 and 332, Supplement to Employment, Hours, and Earnings, United States, 1909-90 (July, 1991), pages 11, 49, and 58; and authors' calculations.

with close-to-average wages.[18] These two industries would probably be considered important ones for the U.S. to keep if it is to move in a high-wage direction. Yet the record shows that the U.S. has been steadily losing jobs in these sectors over the last few years, while U.S. affiliates have been increasing jobs very rapidly in these two sectors in Mexico.

Table 9 shows employment by United States multinationals in electrical and electronic products and in transportation equipment in Mexico, 1986-91, along with total domestic employment in the analogous industries. Motor vehicle and equipment production workers are shown separately for the U.S. because most of the transportation equipment jobs in Mexico are in that industry, whereas the transportation equipment category for the U.S. also comprises the aircraft, ship building,

18. In 1990, the average hourly wage for production and nonsupervisory workers was $10.30 in electrical and electronic equipment and $14.59 in motor vehicles. These may be compared with averages of $10.02 for the entire private sector, and $10.83 for all manufacturing. Data are from U.S. Department of Labor, Bureau of Labor Statistics, *Supplement to Employment, Hours, and Earnings, United States, 1909-90*, July 1991.

railroad, and aerospace industries. Therefore, the transportation equipment category in the U.S. includes some employment trends which are not directly comparable to those in Mexico.

While total United States manufacturing production jobs increased between 1986 and 1989, as shown in Table 8, U.S. domestic employment in these two industries lagged behind. U.S. employment in the electronics industry declined by 80,300 workers (6.8%) from 1986 to 1989, which was before the U.S. recession. In the meantime, Mexican employment in U.S. firms in that industry increased by 33,400 (43.3%) during that period. U.S. domestic employment in motor vehicles declined by 5,800 workers (0.9%), while overall employment in transportation equipment (including aircraft, etc.) increased by 20,700 (barely 1.6%)—just over half the rate for all manufacturing (3.0%). Mexican employment in U.S. firms in the transportation equipment industry increased by 20,700 (28.8%) during the 1986-1989 period.

If we move to 1990, employment in the United States in all the sectors shown in Table 9 fell during the recession. But employment by U.S. MNCs in Mexico in these same industries continued to rise in 1990. Over the whole period 1986 to 1990 these two sectors were responsible for 70,100 new jobs at U.S. multinational affiliates in Mexico, or 75.9% of the 92,300 total new manufacturing jobs in those affiliates over that period. Meanwhile, domestic employment in these two sectors fell by a total of 184,300 jobs over the same period even though total manufacturing jobs increased slightly in 1990 over 1986 (Table 8). Thus, in the very type of industries which the U.S. should be seeking to preserve, the jobs created in Mexico were quite large relative to the jobs lost in the U.S.

The shift in workers was matched by a shift in passenger car production by the "Big Three" auto makers (Chrysler, Ford, and General Motors). In 1987, 87.2% of passenger cars assembled in North America by the Big Three were made in the U.S., and 2.3% were made in Mexico (calculations based on data presented in Herzenberg 1991). By 1989, the U.S. share fell to 83.6% and the Mexican share grew to 3.7%. In absolute terms, U.S. assembly of Big Three passenger cars fell from 6.5 million to 5.8 million cars between 1987 and 1989; a fall in production of 11.2%. In Mexico, on the other hand, production for the Big Three increased from 167,000 to 254,000 automobiles, an increase of 52.1%.

The United States' share of passenger car assembly by all manufacturers in North America declined from 86.9% to 83.4%, while Mexico's production increased from 3.4% to 5.4%. The largest shifts in production were by Nissan and Volkswagen: the U.S. share of Nissan's North American production fell from 66.9% to 57.1%. In 1987, 60.4% of Volkswagen's production was in the U.S. The company now produces autos for sale in North America only in Mexico.

These trends raise the question of why United States firms have been shifting employment in these particular industries rapidly in recent years. Supporters of the NAFTA often argued that the incentives for such job shifts are minimal, because the low wages of Mexican workers are offset by their lower productivity. But while Mexican labor has low *average* productivity, it can be highly productive in sectors where foreign capital has brought in up-to-date technology and management. In domestic corn production, for example, Mexico's productivity is very low. But in sectors such as electronics and automobiles, its productivity has in recent years been converging on that of the U.S. rapidly. As Mexico's productivity has approached America's in these industries, Mexico's wages have remained far lower. Mexico has acquired an enormous competitive advantage in unit labor costs (wages relative to productivity).

The productivity and wages (hourly compensation) of Mexican workers relative to U.S. workers in electronics and transportation equipment are shown in Table 10. The period covered is 1975 to 1984, the latest period for which data on sectoral productivity are available. Much of the convergence in productivity between the U.S. and Mexico is related to the share of the Mexican sector that is made up of U.S. firms. With the increase in U.S. investment in Mexico in these sectors since 1984, it is very likely that there has been even further convergence in productivity.

Table 10
Mexican Labor Productivity and Hourly Labor Compensation,
as Ratios of U.S. Levels, 1975-1984

		1975	1979	1982	1984
Electronic equipment	Productivity	0.63	0.74	0.66	0.83
	Compensation	0.24	0.24	0.20	0.15
Transportation equipment	Productivity	0.53	0.61	0.59	0.57
	Compensation	0.31	0.28	0.20	0.13

Note: Productivity is measured by value added per employee. Transportation compensation is for motor vehicle equipment.

Sources: Magnus Blomstrom and Edward N. Wolff, "Multinational Corporations and Productivity Convergence in Mexico," National Bureau of Economic Research Working Paper No. 3141 (Cambridge, MA: October, 1989): Table 8, page 25; U.S. Dept. of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, *Hourly Compensation Costs for Production Workers, 40 Manufacturing Industries, 34 Countries, 1975 and 1979-89*, Unpublished Data (September, 1990): pages 86 and 95; and calculations of the authors.

Productivity is measured as value added per employee in the industry. The table also shows worker compensation cost (wages plus mandated and negotiated benefits and taxes) differential in the two industries. During the period shown, the cost of employing Mexican workers, relative to the cost of U.S. workers, was declining. In electronics, Mexican workers' wages fell from 24% to 15% of U.S. wages in that industry, and in transportation equipment Mexican workers dropped from 31% of U.S. wages to 13%. Yet in transportation equipment, Mexican workers were between 53% and 61% as productive as U.S. workers. In the electronics industry, the difference is even more stark: Mexican workers were from 63% to 83% as productive as U.S. workers. Thus the unit labor costs of production in Mexico are much lower than in the U.S. It would not be surprising, therefore, to see U.S. companies seeking to increase employment in Mexico relative to the U.S. And again, these are not low-wage industries by U.S. standards. These are "high-tech" (electronics) and capital-intensive (transportation equipment) industries.

The effect of slow job creation in the U.S. is reflected in the stagnant wages and benefits of production workers in manufacturing. As a shift in investment would suggest, there is a possibility of wage convergence. The shift could lead to convergence in wages through two paths. First, if the shifts in employment are for similar positions, the wages of U.S. production workers would drop toward the Mexican wage level. Or, second, if low-wage U.S. jobs are not being created but Mexican jobs are created at higher wages, then wages would also converge. The shifts could lead to a divergence in wages if Mexican wages do not rise as fast through new job creation as U.S. or Canadian wages by the loss of the lowest-wage workers. But Table 11 (next page) shows that this is occurring only in Canada.

Table 11 shows that some convergence is taking place between wages in Mexico and the United States. The real wage of Canadian manufacturing production workers is increasing relative to the Mexican and U.S. work force. During the period 1986-1989 (before the U.S. and Canadian recession), convergence between U.S. and Mexican wages was the result of wages in the U.S. falling faster than wages in Mexico: -4.4% for the U.S. compared to Mexico's -2.4%. But while U.S. manufacturing production wages and employment continued to fall during the U.S. recession, Mexico's production wages and employment continued to rise. As a result, over the period 1986-1991, the convergence in wages is almost equally divided between a rise in Mexican wages (5.3% higher) and a fall in U.S. wages (6.1% lower). Mexican and Canadian wages diverged between 1986 and 1989 because Canadian wages rose while Mexican wages fell. The effect of the Canadian recession was a slowing of Canadian wage growth. For the period 1986-1991, there is some convergence between Canadian and Mexican wages because Canadian wages did not rise as fast as Mexico's.

The pattern of job creation and changes in wages for the period 1986-1990 is consistent with U.S. companies' creating jobs in Mexico that are similar to those no longer being created in the U.S. These data on shifts in employment in specific industries, productivity differences, and compensation differences suggest that the current trends in employment location may be more than short-lived. It should be remembered that six years is a short period, and they include the most recent U.S. and Canadian recessions. The 1990 U.S. recession, as a macroeconomic phenomenon, had many causes and, measured by lost GDP, it was short and shallow. The correlation of employment and wage movements between the U.S. and Mexico in the 1986-1990 period does not prove a causal relationship, and the effect of such a shift on the entire U.S. work force may not be entirely negative. If employment and wages are rising elsewhere, this trend—if it is a trend—would represent only part of the reshaping of the U.S. labor market.

The effect of slow job creation in U.S. manufacturing is also reflected in the wages of U.S. workers. Table 12 shows the wages of U.S. men, by education, for the period 1987-1990. The wages reported are weighted by the number of workers rather than by the number of hours to control for the bias of excluding low-wage workers during economic downturns. The table makes it clear that, for all education levels except two years of postgraduate college study, real wages have been falling. Since only 7.8% of the U.S. male work force has two years of postgraduate college study, this means that real wages have been falling for over 90% of U.S. men during this period. The table

Table 11
Hourly Compensation* of Production Workers in Manufacturing
Canada, Mexico, and the United States, 1986-1991

	Real compensation in home currency (1991 prices)			Real compensation in US$, 1991		
	Canada	Mexico	U.S.	Canada	Mexico	U.S.
1986	19.29	6,221.23	16.46	$16.84	$2.06	$16.46
1987	19.15	5,813.88	16.19	16.71	1.93	16.19
1988	19.32	5,591.26	16.02	16.86	1.85	16.02
1989	19.41	6,071.21	15.73	16.93	2.01	15.73
1990	19.74	6,222.31	15.52	17.23	2.06	15.52
1991	19.84	6,549.00	15.45	17.31	2.17	15.45
Percent change:						
1986-1989	0.6%	−2.4%	−4.4%	0.5%	−2.4%	−4.4%
1986-1991	2.8	5.3	−6.1	2.8	5.3	−6.1

* Hourly compensation includes all payments made directly to the worker (pay for time worked--basic time and piece rates plus overtime premiums, shift differentials, other premiums, and bonuses paid regularly each pay period, and cost-of-living adjustments, pay for time not worked--vacations, holidays, and other leave, seasonal or irregular bonuses and other special payments, selected social allowances, and the cost of payments in kind--before payroll deductions of any kind) and employer expenditures for legally required insurance programs and contractual and private benefit plans.

Source: For wage data and exchange rates, U.S. Dept. Of Labor, Bureau of Labor Statistics, *International Comparisons of Hourly Compensation Costs for Production Workers in Manufacturing, 1991*, Report 825 (June 1992) Table 4, page 8 and Table 6, page 10; for inflation adjustment using consumer price index, International Monetary Fund, *International Financial Statistics*, Volume XLV (April, 1992) Pages 150, 370 and 554; and calculations of the authors.

also shows the real wages of men in 1973, which reveal that the recent declines in wages are part of a longer-term trend. The lower price levels that are supposed to result from the lower unit labor costs embodied in imported goods have not been sufficient to benefit U.S. workers. Instead, the wages of U.S. workers have not kept pace with inflation. So far, only a tiny fraction of U.S. workers have benefited from the mix of U.S. trade and domestic policies.

In addition, the U.S. labor market has shown structural weakening since the late 1960s. Table 13 shows unemployment rates during each expansion and contraction of the U.S. economy, beginning with the peak in March 1969. Until July 1990, each successive peak followed a path of higher and higher unemployment, and even the July 1990 unemployment rate of 5.5% was still well above the rates at the cyclical peaks in 1969 and 1973. Up to 1982, each recession trough occurred

Table 12
U.S. Men, All Industries, All Occupations, Real Wages
(constant US$, 1991, 1973 and 1987-1990)

	High-school drop-out	High-school graduate	Four years of college	College plus 2 years
1973	11.48	13.50	18.99	21.09
1987	9.35	11.55	17.55	20.85
1988	9.29	11.43	17.38	20.74
1989	9.01	11.15	17.13	21.05
1990	8.70	10.88	17.14	21.20
Percentage change:				
1987-1990	−7.0%	−5.8%	−2.3%	1.7%
1973-1990	−24.2%	−19.4%	−9.7%	0.5%

Source: Lawrence Mishel and Jared Bernstein, "Declining Wages for High School and College Graduates: Pay and Benefits Trends by Education, Gender, Occupation, and State, 1979-1991," Economic Policy Institute (Washington, DC: 1992); and authors' calculations.

at a higher and higher unemployment rate. While the most recent recession looks better by the criterion of theunemployment rate, it actually demonstrated worse labor-market performance by other criteria. With the number of jobs virtually unchanged for more than a year after the official recession trough (March 1991), the unemployment rate continued to rise well into the recovery and reached a maximum of 7.6% in June 1992 (shown as the most recent recession trough in the table).[19]

The data reviewed here show that the U.S. labor market has been deteriorating in its ability to provide rising real wages and expanding employment opportunities for the last 25 years. In light of this worsening performance, the enhanced freedom of firms to shift jobs under the NAFTA must be given careful consideration. The protection afforded to cross-border investment shifts under the NAFTA is far greater than the ability of labor markets to handle the resulting shifts in employment patterns, and there is no coordination of labor market policies across the three North American partners.

19. In the first 22 months after the cycle trough (March 1991 to January 1993), the increase of 498,000 jobs was only 0.5% of the pre-recession peak level of total employment. Except for the abortive 1980-81 recovery, this was far and away the slowest job growth in a recovery in any business cycle since the late 1960s. Based on authors' calculations from unpublished U.S. Department of Labor, BLS data for 1992, and the U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, October 1992, for earlier data.

Table 13
Workers in the United States:
Peak-to-Peak and Trough-to-Trough Unemployment Rates
(All civilian workers, seasonally adjusted)

Business cycle peak	**Unemployment rate**
December 1969	3.5
November 1973	4.8
January 1980	6.3
July 1981	7.2
July 1990	5.5
Business-cycle trough	**Unemployment rate**
November 1970	5.9
March 1975	8.6
July 1980	7.8
November 1982	10.8
June 1992	7.6

Note: According to standard criteria, the last cyclical trough was reached in March 1991 when the unemployment rate was only 6.8%. However, due to the unusually slow recovery that followed, unemployment continued to rise for more than a year and reached a peak of 7.6% in June 1992. The latter month is shown in the table.

Sources: Dates of business cycles (except trough in 1992), U.S. Dept. of Commerce, *Survey of Current Business*, Vol. 71 (October 1991): page C-45. Unemployment rates, monthly, seasonally adjusted, U.S. Dept. of Commerce, *Survey of Current Business*, Vol. 71 (October 1991): page S-10, and U.S. Dept. of Commerce, *Business Statistics, 1961-88* (December 1989): page 249.

Indeed, labor market policies in the United States are not prepared to handle the quick shifts in conditions brought about by increased international capital mobility and economic integration. The inadequacy of U.S. policies can be inferred from the data on government spending on labor market programs. Table 14 compares public expenditure on labor market programs in the U.S., Canada, and Germany. Germany is shown since many like to compare the issues faced by the U.S. and Canada by the inclusion of Mexico in a NAFTA with the issues faced by Germany with the inclusion of Spain and Portugal in the EC. The data shown are for the same period shown above, 1986-1990.

Table 14
Public Expenditure on Labor-Market Programs as a Percentage of GDP
Canada, Germany, and the United States, 1986-1990

Country	Program	1986	1987	1988	1989	1990
Canada*	Labor market training	0.35	0.29	0.26	0.26	0.27
	Youth measures	0.02	0.02	0.02	0.02	0.02
	All active measures[a]	0.62	0.55	0.50	0.51	0.52
	Income maintenance[b]	1.86	1.64	1.57	1.57	...
Germany	Labor market training	0.24	0.30	0.32	0.33	0.38
	Youth measures	0.05	0.06	0.05	0.05	0.04
	All active measures[a]	0.91	1.01	1.07	1.02	1.02
	Income maintenance[b]	1.32	1.36	1.36	1.22	1.16
U.S.A.*	Labor market training	0.12	0.11	0.11	0.10	0.09
	Youth measures	0.03	0.03	0.03	0.03	0.03
	All active measures[a]	0.28	0.27	0.26	0.25	0.25
	Income maintenance[b]	0.56	0.51	0.44	0.47	0.60

* For the U.S. and Canada data are for fiscal years beginning and ending with calendar years 1986-87 and 1990-91.

a. Active labor market policies include public employment services and administration; labor market training (including training for unemployed adults and those at risk, and training for employed adults); youth measures (including measures for unemployed and disadvantaged youth, and support of apprenticeship and related forms of general youth training); subsidized employment (including subsidies to regular employment in the private sector, support of unemployed persons starting enterprises and direct job creation in the public or non-profit sector); and, measures for the disabled (including vocational rehabilitation and work for the disabled).

b. Income maintenance includes unemployment compensation and early retirement for labor market reasons.

Source: OECD *Employment Outlook* (July 1991): pp. 239, 241, and 249.

The shifts in job creation that are already occurring, and which are likely to accelerate under the NAFTA, imply that labor training and support for training youth will be very important. Though all three countries invest roughly equal percentages of their GDP on youth, Germany invests proportionally far more than the U.S. or Canada in training for adult workers. Even more disturbing is that during the period under discussion Germany was increasing its commitment to training as the U.S. and Canada decreased theirs. Canada began the period behind Germany in investment in active measures to shape its labor market (0.62% to Germany's 0.91%), but ahead in the key area of training (0.35% to Germany's 0.24%) and slightly behind in youth measures (0.02% to Germany's 0.05%). Only in the area of youth measures are the U.S. and Germany investing at roughly the same rates. At the end of the period (1990) Germany was investing at a rate that was only 0.01% of GDP higher (0.04% for Germany to 0.03 for the U.S.) than for the United States. But, for total active labor market policies, the U.S. is investing in its work force at a rate that is one quarter that of Germany.

There is no support in the current pattern of job creation in the United States for the notion that more of the same policies will lead to increased incomes in the United States. Instead, the current pattern of slow creation of manufacturing production jobs in the U.S. and faster creation of those jobs outside the U.S. exacerbates a longer downward trend in the U.S. labor market. The labor market policies of the U.S. have been inadequate to reverse that trend, and are certainly inadequate to cope with even greater shifts in the labor market. This weak labor market gave U.S. workers great pause during the NAFTA debate. Policies that encourage a shift in U.S. investment in hopes of changing U.S. trade patterns to offset job losses from investment shift are not showing themselves to be sufficient to reverse deterioration in the U.S. labor market. Absent some other policies, if the logic of the NAFTA is pushed into a WHFTA, we would not expect any significant income growth in the United States from U.S. workers moving to higher wage jobs.

Table 15
Mexican Wages as a Percent of GDP,
1980-1990

1980	36.0%
1981	37.6
1982	35.3
1983	29.4
1984	28.7
1985	28.7
1986	28.3
1987	26.5
1988	25.9
1989	15.8
1990	15.0

Note: Data for 1989 and 1990 are, respectively, preliminary and estimated figures.
Source: Instituto Nacional de Estadistica, Geografia e Informatica (INEGI).

It is far from clear that losses for American workers are necessarily gains for Mexican workers. Table 11 showed that the real wages of Mexican production workers fell after Mexico joined GATT in 1986, and returned to that level only in 1990. Only since 1990 have they made real gains from the opening of the Mexican economy. The economy-wide gains of Mexican workers are even less clear. Table 15 shows wages as a share of Mexico's GDP. Prior to the debt crisis, Mexican wages were between one third and two fifths of Mexico's GDP—37.6% to 35.3%. After the debt crisis and before the opening of the Mexican economy, the share of wages fell to slightly under one third of GDP—28.3% to 29.4%. And after the opening of the Mexican economy in 1986, the wage share is estimated to have fallen to around one fourth to slightly less than one sixth of GDP: 26.5% to 15.0%.

Of course, new job creation from foreign direct investment is only one element of the health in a labor market. Any positive effect can be easily dwarfed by macroeconomic policy. In particular, policies aimed at containing inflation by fiscal authorities, or currency management by central bankers can be more important. Workers in the hemisphere may not see the theoretical benefits touted by the economic modelers of trade because of macroeconomic forces that are more important. As an example, Mexico's labor market may not be seeing the benefits of a shift in job creation because of measures taken to keep the peso's exchange value high in order to control inflation, which produced high interest rates and a trade deficit in the early 1990s. The high interest rates in turn tend to shift GDP towards interest payments and away from wages unless productivity can increase at a very fast rate.

Table 16
Employment by Nonbank Foreign Affiliates of U.S. Parent Companies,
Other Western Hemisphere, Selected Countries and the Caribbean,
1977 and 1982-1990 ('000)

	Other Western Hemisphere	Argentina	Brazil	Chile	Colombia	Dominican Republic	Caribbean	Venezuela
1977	976.9	108.0	435.7	10.1	61.3	46.6	49.1	101.2
1982	880.3	80.6	425.6	12.7	54.5	12.6	44.0	102.7
1983	799.7	82.1	377.0	12.6	54.0	10.9	41.8	83.4
1984	786.7	81.0	377.0	12.7	51.7	10.6	41.2	76.4
1985	764.6	70.9	392.0	11.9	50.2	7.4	32.5	74.3
1986	753.3	68.4	403.2	13.2	40.7	9.8	29.2	68.2
1987	795.1	68.4	432.7	12.9	44.2	9.7	29.5	74.3
1988	791.1	67.4	424.6	14.5	45.8	11.6	28.9	71.6
1989	780.7	60.3	440.1	18.6	39.4	18.1	28.0	60.1
1990	781.8	57.7	445.0	22.0	40.1	18.7	27.8	61.7

Note: "Other Western Hemisphere" is the Western Hemisphere excluding the U.S., Canada, and Mexico. The Caribbean column includes the Bahamas, Barbados, Bermuda, Jamaica, the Netherlands Antilles, Trinidad and Tobago, and the United Kingdom Islands.

Source: U.S. Dept. of Commerce, *Survey of Current Business*, Vol. 71 (October 1991): Table 4, page 34; and Vol. 72 (August 1992), Tables 13.1 and 13.2, pages 77-78.

Table 16 shows employment with United States multinationals in Latin America and the rest of the Western Hemisphere except Canada and Mexico, and in specific countries. This table shows total employment with U.S. multinationals including all industries. Overall employment with U.S.-based firms in the hemisphere is down from earlier. The pattern in most countries is a drop in economic activity following the debt crisis in 1982, with a slow recovery beginning in 1985-1986. Job creation from U.S. multinationals has followed the health of the local economies.

However, countries such as Argentina, Colombia, and Venezuela show a persistent decline in job growth from U.S. foreign direct investment. The most dramatic growth has been in the Dominican Republic, though this is still far below the higher levels of the 1970s. The Dominican Republic, like Mexico, has an "in-bond" manufacturing sector that enjoys favorable duties in the United States. It is also closer to major U.S. markets than many other countries in the hemisphere.

Chile has also experienced growth, but not in manufacturing. Most Chilean jobs with United States-based companies are in other industries. If a WHFTA reinforces current trends, then it is not likely that many other countries will see investment-led job growth in manufacturing unless their economies are healthier. And it is possible that if barriers are lowered for intrahemispheric trade, the investment that has been induced to avoid trade barriers may not be present even if the local economies are healthier. Existing job creation patterns, like the trade patterns discussed in the previous section, may create more pitfalls for the poorer Latin American countries.

4. Foreign Investment and the Macroeconomics of Western Hemisphere Integration

It is clear from the preceding discussion that the main impetus for the NAFTA and WHFTA proposals, both for American business and for Latin American governments, is the prospect of massive new infusions of foreign investment (especially direct investment) into Latin America. This section will analyze recent trends in U.S. foreign investment in Mexico and what those trends imply for future growth and job creation in North America. As before, this study will consider the extent to which these trends are likely to be followed in the rest of Latin America under a WHFTA.

Creating an Integrated Capital Market

Although the NAFTA is, on the surface, a trade liberalization agreement, in fact it is just as concerned (if not more so) with *investment liberalization.* The NAFTA contains stringent and unprecedented guarantees for foreign investment in each country, intended mainly to secure U.S. multinational firms from nationalization or even more moderate restrictions on the mobility of their capital invested in Mexico. Coupled with provisions to liberalize trade in financial services, it is clear that the goal of the NAFTA is to create an *integrated capital market* along with an integrated goods market—although no integration of labor markets was contemplated. NAFTA will therefore have repercussions for capital flows both within North America and with other regions. This makes it imperative to consider the macroeconomic repercussions of what is really a free trade *and investment* agreement.

Macroeconomic Repercussions for the United States[20]

It is ironic that the prospects for increased capital mobility under NAFTA have been the source for the biggest projected gains *and* losses in output and employment for the United States. American NAFTA supporters such as Dornbusch (1991) and Hufbauer and Schott (1992) argue that an increased net capital outflow from the U.S. to Mexico will improve the U.S. current account balance, *ceteris paribus*, and thus raise U.S. GDP and employment.[21] American NAFTA critics such as Koechlin et al. (1992) have assumed that increased foreign investment in Mexico comes largely if not exclusively at the expense of domestic investment in the U.S., thus causing losses of output and employment there.

To sort out this debate, it is necessary to recall the national income identity:

$$GDP = C + I + G + (X - M),$$

where C is personal consumption expenditures, I is gross domestic investment, G is government purchases, X is exports of goods and services, and M is imports of goods and services.[22] Based on this identity, it is clear that both sides in the debate took only partial and incomplete approaches to the question of income determination (and employment determination, assuming employment is roughly proportional to GDP in the short run). The supporters looked mainly at the likely changes in the trade balance, $X-M$, arguing that these are likely to be positive for the U.S. The critics looked mainly at the domestic investment term I, claiming that it is likely to be reduced in the U.S. Critics also tended to argue that the U.S. trade balance $X-M$ would be decreased by the NAFTA, as the U.S. imports more labor-intensive manufactures from Mexico. Each side implicitly assumed that the effects considered by the other side either would not happen or would be inconsequential.

A more complete analysis must address both the question of how much foreign capital will be invested in Mexico as a result of the NAFTA, and the degree to which this capital will be diverted from domestic investment in the United States. Consider, for example, a decision by an American corporation to relocate a particular production activity from Michigan to Monterrey. This will entail capital outflows and, at least initially, reduced investment at the company's facilities in the U.S. The question is whether that reduced investment will automatically be replaced by some other investment. Supporters of NAFTA essentially assumed that this corporation or other corporations would

20. The discussion in this section draws heavily on Blecker (1993), which provides a formal mathematical model for some of the relationships discussed here.

21. Of course, this argument implied that Mexico would have increased trade deficits. But this need not reduce employment in Mexico, and may even increase it, if one assumes that Mexican industry operates at full capacity. With output and employment constrained by available capital, a current account deficit brought about by increased capital inflows can relieve the domestic savings and foreign exchange constraints in a two-gap model, thus permitting increased investment and capital accumulation.

22. In the American national income accounts, public sector investment is included in G; most other countries' national accounts include public sector investment in I. Using GDP as the income aggregate, the trade balance $(X-M)$ excludes net factor income (factor service receipts) from abroad. Those would be included if a GNP aggregate were used instead.

necessarily fill the void by investing in new activities, perhaps targeted at exports to Mexico. Critics of NAFTA questioned whether this is likely to happen.

Traditional neoclassical economic theory, which assumes that investment is determined by available savings, implies that the savings thus released will necessarily find a more profitable outlet somewhere else in the country. But *even that conclusion need not hold once the capital markets of the two countries are integrated.* That is precisely why the capital market integration features of the NAFTA are so important. Even if investment is constrained by savings in the aggregate, in an integrated North American capital market that would only imply that *North American* savings would have to be used to finance investment *somewhere* in North America—not necessarily in the country where those savings originate. And if one takes the Keynesian view that investment is the independent variable, and savings adjust (through changes in income levels and factor shares), then there is not even any sense in which there is a predetermined amount of savings "released" which must find an outlet somewhere. In that case, there could be no presumption of the foregone domestic investment being replaced.

The issue of capital flows is further complicated by the potential for investment diversion effects. For example, a U.S. (or foreign) corporation with operations in several countries could decide to increase its investments in Mexico at the expense of its investments in another developing country, rather than at the expense of its investments in the United States. This would bring new foreign capital into Mexico, but without producing capital outflows from the U.S. As an alternative, a foreign corporation seeking access to the U.S. market could decide to invest in Mexico rather than in the U.S. itself, once trade barriers were eliminated. This would reduce domestic investment in the U.S., but without creating a capital outflow from the U.S. that would improve the trade balance. Given these complexities, it is hard to know *a priori* whether the increase in $(X-M)$ or decrease in I will predominate in the U.S. macroeconomy. The estimation of the relative importance of the different factors involved is an important priority for research on this topic.

Furthermore, the dynamics of the foreign capital flows must be considered. Presumably, a large capital outflow is the result of a stock-adjustment process. American firms respond to lower perceived risks and higher expected discounted profits from operations in Mexico, as a result of the trade *and* investment liberalization provisions of NAFTA, by increasing their desired stocks of capital in Mexico. Capital outflows then occur over time as needed to bring actual stocks of U.S. assets in Mexico into line with the new desired level. Considerable lags may prolong this adjustment process because of such factors as sunk costs in U.S. facilities, learning about suitable foreign locations, obtaining the necessary financing, training of workers, construction of new facilities, etc. Investment projects may also be delayed by slowdowns in demand growth (the accelerator effect) or shortfalls of cash flows (which may constrain external as well as internal financing in imperfect capital markets). In addition, some of the increased investment in Mexico is financed with locally raised capital, which does not result in capital outflows from the U.S.

Once the new level of desired foreign capital in Mexico is reached, we would expect the net new capital outflows from the U.S. to be reduced. At that point, the U.S. trade balance with Mexico would fall.[23] At best, then, the prediction of huge net capital outflows is valid for the short-to-medium run, but is not likely to be sustained in the long run. And even this analysis assumes a stable adjustment of foreign capital in Mexico to a new desired level; the swings in the balance of payments could be even more dramatic if there is a boom-bust cycle characterize by overinvestment in Mexico in the short run followed by a subsequent withdrawal of capital as occurred in U.S. bank lending to Latin America in the late 1970s and early 1980s.

What will be sustained in the long run are the changes in the competitiveness of each country's industries that follow from the new locational pattern of investment. In this respect, the long-term consequences for the U.S. trade balance could well be negative, once the net capital flows (and the associated exports of capital equipment produced in the U.S.) fall off. As argued in the previous section, if plants located in Mexico are able to combine highly productive modern technology with continued low wages to produce manufactured goods with comparatively low unit labor costs, they can undersell American products in a wide range of products including some that are apparently "capital-intensive" or "high-tech" (such as autos and electronics). Such competitive advantages could be offset by appreciation of the peso, by increased wages of production workers in Mexico, or by shifts of U.S. manufacturing into more knowledge-based products where labor costs are less important. But even if the net effects on U.S. employment are minimal in the long run, the gross job losses and dislocations in sectors such as automobiles, textiles, and electronics are likely to be considerable.

The integration of capital markets also has important implications for the exchange-rate dimension of the NAFTA and, by extension, of a WHFTA.[24] The peso is somewhat overvalued in real terms. This is partly a deliberate consequence of Mexico's anti-inflationary policies, and partly the result of the increased capital inflows into Mexico in recent years, and in turn helps to account for Mexico's growing trade deficit in the early 1990s. Indeed, the real appreciation of the peso is an important "transmission mechanism" for endogenously making the trade balance adjust to the capital account surplus (just as occurred with the U.S. dollar in the early 1980s). If the NAFTA causes capital inflows into Mexico to grow even more, and if Mexico retains its current anti-inflationary fiscal and monetary policies, the peso could rise even more in real terms in the short run. This would help ameliorate the possible negative effects of any investment shifts on the U.S. by making Mexican products relatively less competitive and helping to ensure a bilateral U.S. trade surplus with Mexico over the first few years of the agreement. But this would also lessen some of the short-term gains to Mexico. And this is also a warning to other Latin American countries contemplating entering a WHFTA; Latin American countries have a long history of micro-level export-promotion policies that fail partly because of exchange rate misalignment.[25]

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23. The current account balance would fall less than the trade balance due to increased net inflows of investment income. However, net investment income is not included in the $(X-M)$ term when the national income identity is defined in terms of GDP.

24. The following discussion was suggested by a conversation with Daniel Schydlowsky.

25. Often, Latin American currencies have become overvalued as a result of high differential inflation rates (relative to the industrial countries) not fully offset by nominal devaluations. While the current Mexican case is similar in this regard, the Mexican government is doing this consciously as an anti-inflationary measure.

In the long run, however, the overvaluation of the Mexican peso cannot be sustained indefinitely. Once the net capital inflows fall, there will be downward pressure on the peso and it will be in Mexico's competitive interest to allow that to happen, assuming fears of high inflation have subsided by then. This would threaten the U.S. with trade deficits, but there would be little the U.S. could do as there is no agreement in the NAFTA to stabilize exchange rates. As in Europe, then, *the integration of commodity and capital markets will bring pressures for exchange rate management, macroeconomic policy coordination, and possibly a monetary union.* While no politicians in North America have dared to make such suggestions yet, the European experience suggests that they may not be far off. The recent conflict between Germany and the other countries in the European Monetary System (EMS) over interest rates and exchange-rate parities demonstrated the problems that smaller countries can face when the hegemonic power in a trading (and monetary) bloc decides to base its policies on domestic considerations, with no concern for the effects on the other states in the bloc.

These same dynamics of capital flows, investment shifts, and exchange-rate effects will be played out across Latin America to a greater or lesser extent, and with different variations, if a WHFTA is created. One would expect, however, that the total amount of U.S. capital that might move to Latin America over the next few decades is not unlimited, and that the addition of more countries to the Western Hemisphere trading bloc will only dilute the effects on any individual country such as Mexico. Thus, the formation of a WHFTA is not likely to add greatly to the aggregate costs and benefits to the U.S. of integrating its capital market with Mexico, but it could divert some of the gains Mexico hopes to realize to other Latin American countries. Indeed, the fear of diversion of capital to Mexico under a NAFTA may account in part for the interest of some other Latin American countries in joining a WHFTA when prospective trade gains alone are not likely to be large.

Recent Trends in U.S. Foreign Direct Investment in Latin America

It is often argued that the amounts of U.S. FDI in Mexico are inconsequential for its economy. It is true that the magnitudes are small, although how small depends on the basis of comparison. The largest predictions of job gains or losses for the U.S. from NAFTA are on the order of 500,000, less than 0.5% of total U.S. employment. Nevertheless, just as the job creation by U.S. MNCs in manufacturing in Mexico has been substantial in comparison with the job creation in domestic U.S. manufacturing, so the increases in U.S. FDI in manufacturing in Mexico have also been impressive.

Often, the magnitudes of FDI are dismissed as negligible by comparison with total U.S. gross private domestic investment, which has been on the order of $700-800 billion since 1987. But this total includes roughly $200 billion of residential investment, which is clearly internationally immobile, as well as some nonresidential structures and equipment that are also largely irrelevant to the issues in the NAFTA debate (e.g., commercial and office buildings). Since most of the concern in this debate is over the fate of American manufacturing, the most relevant benchmark is new plant and equipment expenditures (NP&EE) in domestic manufacturing.

Table 17 presents data on U.S. FDI in manufacturing to Mexico and other developing countries over the last five years, compared with U.S. domestic NP&EE in manufacturing. At first glance, even these FDI figures look small by comparison. As of 1991, total FDI in manufacturing in all developing countries was only about 4% of domestic NP&EE in manufacturing, of which about one third went to Mexico. But what is more noteworthy are the trends in these data. While U.S. domestic NP&EE rose by only 30% from 1987 to 1991, *manufacturing FDI by U.S. multinationals in all developing countries rose by 69%, and U.S. manufacturing FDI in Mexico rose by 222% (i.e., more than tripled) during the first four years following Mexico's liberalization of foreign investment rules.*

The extent to which this extraordinary growth came at the expense of domestic investment in the United States versus foreign investment in other countries is impossible to tell. Some evidence for investment diversion is found in the fact that the Mexican share of all U.S. FDI in manufacturing in developing countries rose from 19% in 1987 to 35% in 1991. U.S. domestic NP&EE in manufacturing fell in 1991 due largely to the recession, but could possibly have been higher than it actually was if capital outflows to Mexico (and other countries) had not continued to be strong. It is plausible, although there is no definitive proof, to surmise that the unusually sluggish behavior of domestic investment in the U.S. economic recovery in 1991-92 may have been due, to some degree, to the fact that American and foreign companies were shifting their North American manufacturing investment to other nations such as Mexico.

Finally, the data in Table 17 may give some hints about the interest of other Latin American nations in a hemispheric FTA with similar provisions on foreign investment. After a boom in 1988-89, U.S. FDI in manufacturing in other Latin American countries fell off sharply in 1990 and 1991 while the FDI in Mexico continued to grow. It is possible that the rest of Latin America was already feeling some diversion of U.S. FDI to Mexico. This would support the view that the rest of Latin America seeks a WHFTA in part as a defensive move to prevent Mexico from capturing a larger share of U.S. FDI (as well as trade) in the western hemisphere.

The Question of Markets

In all of the discussions of the NAFTA and WHFTA there has been remarkably little attention to the problem of generating effective demand sufficient to utilize fully the increased productive capacity that would result from greater capital flows and technology transfers. Indeed, there is considerable incongruity between the expectations of Mexicans and other Latin Americans that export-led growth will cure their economic ills on the one hand, and on the other the current concerns in the U.S. and the EC—the main sources of demand for Latin American exports—that the 1990s will be a decade of slow growth. It would be tragic for Latin America if it were to embark on a liberal trading regime for the first time in over a half century, only to find that the industrialized countries were entering a period of depressed global market expansion.

In the mid-1980s, the great motor of world demand growth was the expansionary fiscal policy of the United States under President Ronald Reagan. U.S. budget deficits, coupled with debt-financed spending by American businesses and households, contributed to huge trade deficits at a time when most foreign countries were pursuing contractionary macro policies (Blecker 1991a, 1992). The resulting trade surpluses for Japan, the former West Germany, and the East Asian NICs (principally South Korea and Taiwan) in the mid-1980s in turn stimulated their economies, and in the late 1980s led to pressures on those countries to appreciate their currencies and expand their demand in order to

Table 17
U.S. Direct Investment in Manufacturing in Mexico and Other Latin American and Developing Countries, 1987 to 1991
($ billion)

	New plant and equipment expenditures in U.S. manufacturing	U.S. direct foreign investment (sum of capital outflows plus reinvested earnings)			
		Mexico	Other Latin America	Other developing countries	Total developing countries
1987	141.1	0.8	1.8	1.7	4.3
1988	163.5	1.3	3.0	1.6	6.0
1989	183.8	1.6	5.7	1.6	8.8
1990	192.6	2.4	3.2	2.4	8.1
1991	183.6	2.5	2.0	2.6	7.2
	Percent of U.S. new plant and equipment expenditures				
1987		0.56%	1.26%	1.19%	3.01%
1988		0.82%	1.86%	0.97%	3.65%
1989		0.86%	3.10%	0.84%	4.81%
1990		1.27%	1.66%	1.26%	4.18%
1991		1.39%	1.09%	1.44%	3.91%
	Rate of increase, 1987-91				
	30.2%	221.9%	11.8%	57.8%	69.0%

Sources: U.S. direct investment abroad is from U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business*, various August issues; new plant and equipment expenditures for U.S. domestic manufacturing are from Bureau of the Census data reported in U.S. Congress, Joint Economic Committee, *Economic Indicators*, June 1992, p. 10; and authors' calculations.

redress the "global imbalances." Thus soaring American demand for foreign products spilled over into an economic boom in the 1980s, a less than global boom since most of Latin America and sub-Saharan Africa were left out.

But the 1980s are past, and the proverbial chickens have come home to roost. In 1990-91 the U.S. suffered a recession which, although not unusually deep, was unusually prolonged. Although the recession officially ended in mid-1991, the annual growth rate from 1991 to 1992 was only 2.1%, and the prerecession peak real GDP of $4,902.7 billion (in constant 1987 dollars) in second quarter 1990 was not surpassed until the third quarter of 1992.[26] With a budget deficit on the order of $300 billion, a national debt approaching $4 trillion, and an annual net interest bill of over $200 billion,[27] the U.S. government was unable to play its traditional countercyclical role in stimulating the economy during the recovery.

At the same time, U.S. corporations and households have been struggling with huge debt overhangs and are reluctant to increase capital expenditures. Banks in turn are seeking to restore their balance sheets after more than a decade of imprudent lending (which continued domestically after they were curtailed in Latin America) and are rationing credit even to creditworthy customers. The legacies of the excesses of the 1980s have become obstacles to renewed U.S. growth in the 1990s.

In February 1993 President Clinton revealed his economic program, which combined a modest fiscal stimulus with larger tax increases, with the net effect of cutting the projected annual federal budget deficit by about $140 billion by 1997. This essentially contractionary shift in fiscal policy will further slow the medium-term growth of the U.S. economy while holding other factors constant. Reductions in long-term interest rates and further dollar depreciation could partly offset the contractionary effects of reducing the budget deficit, but the most likely scenario is for continued slow growth of the U.S. economy in the mid-1990s. Putting all this together, the prospects for rapid growth of the U.S. consumer market in the 1990s are poor.

The picture is not much better in other potential markets for Latin American exports. European growth has been slowed by the high interest-rate policy of Germany, adopted by the Bundesbank in response to the high fiscal costs of integrating the former East Germany into the Federal Republic. On the other side of the world, Japan is in a recession and most of the other major economies of East Asia are competitors of Latin America rather than potential markets.

For Latin America all of this implies that this is a particularly risky time to be putting all of its eggs in the one basket of a FTA with the United States. Especially if the Latin American nations are counting on exports to the U.S. to fuel their own recovery and growth, they could be setting themselves up for a major disappointment. Of course, their exports can grow in the short run as industry relocates to Mexico or other Latin America nations, either at the expense of American manufacturing or through investment diversion from East Asia. But these will be one-time static gains unless the overall U.S. market starts to grow again.

In this century, Latin America has had a long and sorry history of implementing new development strategies just when the conditions that motivated them passed. Import substitution policies were largely a response to the stagnation of the 1930s, when global depression led to collapsing commodity prices and the wartime shortages of the 1940s. But import substitution policies were pursued most strongly between the 1950s and the 1970s, when global markets were generally

26. Data from U.S. Department of Commerce, Bureau of Economic Analysis, "Gross Domestic Product: Fourth Quarter 1992 (Preliminary)," release of February 26, 1993, and U.S. Congress, Joint Economic Committee, *Economic Indicators*, December 1992.

27. Data from U.S. Congress, Joint Economic Committee, *Economic Indicators*, December 1992.

booming and those developing nations that did choose an export-oriented strategy did relatively well. In the 1980s, the East Asian NICs took advantage of the United States' open markets and demand-driven boom to achieve rapid export-led growth, while most Latin American countries were struggling to recover from the debt crisis and to implement "stabilization" and "structural adjustment" policies. Now, just when Asia and Europe are turning inward and the U.S. economy has stagnated, Latin America should think twice before accepting a WHFTA as the only framework for growth.

In this context, it is also important to consider the macroeconomic consequences of the distribution effects of the NAFTA or a WHFTA. The implication of the analysis in section 3 above is that these FTAs are likely to increase the share of profits (capital income) in national income both in the U.S. and abroad—in the U.S. by reducing the bargaining power of industrial workers, and in Mexico by raising the productivity of labor relative to real wages (which are likely to be held down by surplus labor supply). The redistribution of income toward profits could only be exacerbated in a wider WHFTA, if more poor countries end up competing over who can offer the lowest wages (as well as the lowest taxes and least regulatory controls) to foreign capital.

Structuralist macroeconomic theory (Taylor 1983, 1991) implies that such a redistribution toward capital can have a depressing effect on overall aggregate demand since workers have a higher marginal propensity to consume than capital owners. A redistribution of income toward profits thus raises the average saving rate by giving a greater weight to incomes that are saved at higher marginal rates. But this in turn reduces effective demand through the Keynesian "paradox of thrift." This implies that even consumer demand (C in the national income identity above) could be adversely affected by FTAs with investment liberalization in the Western Hemisphere. And if that happens, Latin American nations counting on the U.S. market to fuel their own export-led growth will also suffer.

There are potential offsets to this loss of consumer demand from wage earners. Reduced prices of consumer goods due to production with cheaper labor could help to preserve purchasing power over tradeable consumption goods, although this would not help in regard to nontradeable goods and services. Investment demand, stimulated by the higher profitability, could substitute for consumption demand. Exports to other regions of the world economy such as Europe, Asia, or the Middle East could replace some domestic demand. And finally, demand for luxury consumption goods by upper-income groups throughout North and South America could substitute for workers' demand for basics, a phenomenon already observed in the United States during the so-called consumption binge of the 1980s (Blecker 1991a). But all of these offsets, even if realized, would imply a new pattern of growth based on low wages and highly unequal income distribution, with the benefits of the growth skewed toward the wealthy throughout the trading bloc.

5. Conclusion: The Political Economy of an Integrated Western Hemisphere

This paper has raised questions and point out potential problems with the NAFTA and its proposed successor, the WHFTA. Definitive answers to many of the questions posed here are not yet possible. Nevertheless, if the reader has thought critically about the current rush to form FTAs in the Western Hemisphere, and has taken seriously some of the likely obstacles, then this paper will have served to advance the discussion. At a minimum, the paper has suggested an agenda for future research on issues that are critical to understanding how FTAs will affect the majority of persons in the Western Hemisphere.

Hemispheric integration is far from a free lunch and far from certain to be the panacea it is often made out to be. This concluding section identifies the main policy issues that are likely to be important in future hemispheric negotiations and may determine the eventual social impact of the integration process.

NAFTA is no mere agreement to liberalize cross-border trade. It also contains a set of rules that provide guarantees to foreign investors and a set of restrictions on the kinds of domestic economic regulations and industrial policies member countries can adopt. It does allow for the continuance of some degree of consumer health and safety regulations, but it does less to prevent "environmental dumping" of pollution produced at the site of production. Moreover, it does little to guarantee the enforcement of humane labor standards and workers' rights throughout North America. Thus goods that were produced in factories which dump toxic wastes or expose workers to harmful substances in one country could not effectively be kept out of the other countries under the NAFTA. Given the looser enforcement of such laws in Mexico today, NAFTA alone could provide incentives for multinational firms to circumvent U.S. environmental and labor standards by moving production to Mexico, and that would in turn make it harder to maintain and strengthen environmental and labor standards in the United States. A WHFTA patterned on the original NAFTA would only worsen these problems, especially if it encourages more countries to offer lax environmental protection and weak worker rights to attract foreign investment.

The history of modern efforts at economic integration shows that, if successful, the liberalization of trade and investment eventually leads to moves for further social and political integration as well as macroeconomic policy coordination. The European Community is a case in point, in spite of its current difficulties. In an integrated North American market for goods and capital, citizens of all three countries will inevitably become more aware of conditions in neighboring countries. And since such an integrated market will make workers and communities in the three countries compete against each other for jobs, labor market conditions and social externalities throughout North America will become subjects of legitimate public debate and concern. Thus while NAFTA itself is likely to create pressures to level social regulations downward, there will be (and already are) countervailing political pressures to level them upward instead. The realization that investors have been protected far more than workers, consumers, or the environment led to calls for extending the protections of the NAFTA beyond what it initially encompassed.

These same considerations apply to the more strictly economic consequences of trade and investment liberalization. Potentially massive dislocations of labor in all the countries involved could have a regressive impact on income distribution even if *net* changes in employment are relatively small. These problems must largely be dealt with by domestic institutions and policies that can be adopted unilaterally by each member of NAFTA. In particular, there is a desperate need to strengthen policies such as adjustment assistance and labor retraining for workers who lose jobs, as well as to work on the eventual international harmonization and enforcement of labor standards. Mexico also has serious needs in this area and might require foreign financial assistance to address them. It would also be in the interest of the U.S. to provide such assistance, in order to relieve migration pressures. The manner in which these concerns were dealt with in the NAFTA will set important precedents for eventual WHFTA negotiations.

Finally, nations will not be able to combine their economies successfully to the degree implied by NAFTA without eventually having to coordinate their monetary and macroeconomic policies. This is a central lesson of the European experience, and it is confirmed by the fact that the recent *lack* of policy coordination between Germany and the other countries in the EMS made that system of exchange-rate parities unsustainable. All of North America will have to have reasonably consistent fiscal and monetary policies in order to keep interest rates and inflation rates in line, and thus to prevent destabilizing exchange-rate fluctuations and balance-of-payments crises. For all practical purposes, this means that the Bank of Canada and Banco de México will have to subordinate their monetary policies to the U.S. Federal Reserve until a more international monetary authority is established. In effect, the Canadian dollar and Mexican peso will have to be pegged more closely to the dollar, in real (inflation-adjusted) terms. Such problems of coordination would only be multiplied in a WHFTA.

In all of this, the need to provide expanding markets for the products of all member nations of the FTA (NA or WH version) will have to be met. Anti-inflationary policies, while necessary at times, have a contractionary bias, and if combined with regressive income distribution could lead to chronically depressed demand. Many of the problems this paper has identified, including especially the problems of labor dislocation, could be ameliorated if growth is robust and new jobs and opportunities are continuously created. A stagnant hemispheric economy, on the other hand, is bound to stir more conflict both within and between nations. There will have to be renewed attention on reviving domestic growth, consistent with maintaining low inflation and preventing environmental degradation. These are fine lines indeed to draw and walk, but if they are not handled correctly the whole process of Western Hemisphere integration is unlikely to succeed in the long run.

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STRATEGIES FOR TRADE LIBERALIZATION IN THE AMERICAS

Graciela Chichilnisky

Introduction: Trading Blocs and the GATT

Regional free trade zones have been unexpectedly successful in the last decade. Since 1980 the European Community enlarged significantly its membership and its scope. It now includes southern European countries, and market-integrating features allowing goods, people, services and capital to flow freely around an area accounting for about one fourth of world economic output.

In what appears to be a strategic response, the United States has entered into similar agreements with its neighbors. The recent trading and investment agreement with Canada was signed after many decades of doubtful consideration, and the trend is expanding to the rest of the Americas starting with Mexico. This trend is observed also in other regions. The six members of the Association of South East Asian Nations—Singapore, Malaysia, Thailand, Indonesia, the Philippines, and Brunei—have began this year to build their ASEAN free trade area AFTA as a future counterweight to other international trading blocks, even though at present most of their trade is with Europe, Japan and the US and not with each other. The Japanese have increasingly focused their economic attention in their own region, leading to more investment in and imports from the new East Asian manufacturing exporters. Even the Andean pact seems to be progressing in Latin America after several decades of aimless discussions, with MERCOSUR following suit.

The relationship between the multilateral trade system (MTS) and the success of the regional trade pacts raise disparate reactions. One view is that the emergence of regional trade pacts is a step in the right direction. In this view free trade is not defunct, but rather being organized and approached differently. But another, quite natural, reaction is to fear that "customs unions," as regional free trade pacts are usually called, are inherently opposed to global free trade. Do custom unions increase free trade with insiders at the cost of diverting trade with outsiders? Since the classic works of Meade (1955) and Viner (1950) classifying the issues into trade creation and trade diversion, there has been little conceptual advance on this issue. But the issue is very alive today, and requires our full attention.

It is the purpose of this paper to re-examine the positive and negative aspects of trading blocs as they relate to gains from free trade. The paper is primarily a discussion of conceptual issues, although it is based on facts and on particular cases which are of interest to the trade liberalization in the Americas.

We take a somewhat different approach to a familiar issue. Rather than asking the standard question of whether regional blocs help or hinder global free trade, we ask a more detailed question: what type of customs union is likely to lead to a trade war between the blocs, and what type of custom union is, instead, likely to lead to expanded global trade. In practical terms: what type of trade policies within the blocs will provide economic incentives for expanding free trade.

We shall compare the impact on the world economy of free trade blocs organized around two alternative principles: one is traditional comparative advantages, the other is economies of scale. The aim is to determine how the patterns of trade inside the blocs determine the trade relations among the blocs.

The paper has four parts. The first part reviews the existing economics of trading blocs, and uses this to explain the current situation in the EC and NAFTA. The second part presents a new conceptual approach to the economics of preferential trade, focusing on the internal organization of trading blocs and the economic incentives that this generates with respect to the rest of the world. The third part is a conclusion which pulls the arguments together for an evaluation of NAFTA and an American free trade zone, and of global free trade. The fourth part is an Appendix which provides a formal general equilibrium model of trading blocs with increasing returns to scale and proves the mathematical results which underlie the discussion in the text.

Part I. The Economics of Trading Blocs

Free Trade and Market Power

The last ten years have seen new developments in international trade, focusing on the study of economic dynamics and of market imperfections leading to strategic issues in game theory and industrial organization. But the central tenet of the theory remains the Pareto efficiency of the static and competitive world market. In competitive markets, free trade leads to Pareto efficient allocations. There is no way to make someone better off without making someone else worse off. This is a general proposition which holds for several countries and several markets interacting with each other simultaneously. Called the first theorem of welfare economics, the result that static competitive markets have Pareto-efficient equilibria seems to loom the larger, the more special cases of market imperfections are pointed out.

In view of the efficiency of competitive markets, the failure of the MTS to bring countries to an agreement about a world of free trade seems, at a first sight, irrational. It would appear that countries act as if they could, but prefer not to, achieve a Pareto efficient allocation. Indeed, some believe that the failure of GATT is simply a version of the well-known prisoners' dilemma. The words "prisoners' dilemma" are used to describe a generically inefficient situation, one which, with appropriate coordination, can be altered so as to increase the welfare of each and all players.

Such a view would be incorrect. The problems derive not from irrational behavior, nor from a lack of coordination or "prisoners' dilemma." The reason is that while free trade in competitive markets leads to Pareto optimal solutions, free trade may not lead to Pareto efficient allocations when the countries are large and have market power. For example, large countries may freely choose the quantities they export in order to manipulate to their advantage world market prices, much the same way that a monopolist freely chooses to supply a quantity that maximizes its profits considering its impact on prices, inducing Pareto inferior allocations. For free trade to be Pareto efficient markets must be competitive, and countries must have no market power. When countries are sufficiently large to have an impact on market prices, then they often have an incentive to impose tariffs on each other.

Furthermore, under classical assumptions, a move from tariffs to free trade will typically make some countries better off but other countries worse off. It is true that if a competitive allocation were reached, it would be Pareto efficient. But in a world with tariffs, as we have today, under traditional assumptions some country will loose if free trade is adopted.

One may ask why large countries have protectionist incentives? The reason is that it is possible for large countries to improve their welfare by improving their terms of trade. This is of course not true in competitive markets where the traders, by definition, have no impact on prices. But the theory of trade proves that under traditional assumptions, a large country does have an economic incentive to impose tariffs on others. This is the standard theorem on the existence of optimal tariffs, which is discussed in more detail in Part II, below. A tariff can improve the terms of trade of a large country, even though it may distort its production and consumption. What the theorem says is that, under traditional assumptions, there is always an optimal tariff, one at which the gains from improving its terms of trade through tariffs exceeds the losses due to distortions. A textbook analysis of a simple case is found, for example, in Krugman and Obsfelt (1988). This theorem is widely accepted, understood and applied.

The argument in favor of optimal tariffs is not true for small countries. It is essential that the country should be large enough to have the ability to have an impact on prices. Furthermore the larger is the country, the more market power it has, and the more it can gain from imposing tariffs on others. The implication of this is that if a world of small competitive economies merges into a few trading blocks, then under traditional assumptions, after the blocks are formed, there are more incentives for imposing tariffs than before. In other words, regional free trade associations, under traditional conditions, lead to protectionism. The optimal tariff which we have just discussed is imposed by one country on others unilaterally. The theorem does not consider the possibility of retaliation by other countries. But what if they retaliate? What if other countries also impose tariffs in response?

We now move to a world of strategic considerations, a world with tariff wars. Each country imposes tariffs on each other, and does so strategically so as to maximize its welfare given the actions of others. The outcome of this tariff game was studied in Kennan and Riezman (1988, 1990). If each country chooses as its tariff the best response to the others', a market equilibrium with tariffs is reached. We call this an optimal tariff equilibrium to distinguish it from the free trade equilibrium.

In an optimal tariff equilibrium some countries are better off than they would be at a free trade equilibrium, Kennan and Riezman (1988, 1990) and Riezman (1985). In other words, not all countries would benefit if the world were to move from the optimal tariff equilibrium into a world with free trade. Furthermore, these works show that the larger the country, the more it can improve its welfare at the optimal tariff equilibrium from the level that it could achieve at a free trade equilibrium

To a certain extent the current situation in the world economy can be described as an optimal tariff world. Each country imposes tariffs on others strategically. In this light the difficulties of the MTS have a reasonable explanation. The unwillingness of countries to agree to multilateral free trade is neither irrational nor a coordination problem. It is a rational response to economic incentives of countries with market power.

One immediate implication is that, under traditional conditions, regional trade blocs which increase the market power of the market participants will naturally lead to tariff wars. The larger is the market power of a trade bloc, the larger is its incentive to impose tariffs on others. Even after retaliatory moves are taken into account the same proposition holds: the larger the market power of the bloc, the greater is its possible gain from a tariff war. Therefore if the formation of regional trade blocs increases the market power of the participants, the creation of regional free trade zones encourages trade wars.

We have remarked that the results on optimal tariffs and on the optimal tariffs equilibria hold under traditional assumptions. Since each of these results predicts that regional free trade zones create incentives against global free trade, it becomes crucial to examine the role of these traditional assumptions closely. For whenever these conditions are satisfied, regional free trade inevitably leads to trade wars. And the larger the free trade zones, the more likely is that they will lead to trade wars.

We shall examine these conditions in some detail in the next section. This examination will be conceptual, but focused on particular cases of immediate interest. Drawing on classical results on tariffs of A. Lerner (1936) and of L. Metzler (1949), and on new results on trading blocs with economies of scale Chichilnisky (1992) reported also in the Appendix, we shall show that if the blocs are organized internally around the principle of economies of scale, the optimal tariff theorem breaks down. This means that, under conditions of increasing returns, it is not true that a country is better off by the unilateral imposition of a positive tariff on its imports. But before we turn to the new results, we shall explore the implications of the optimal tariff theorem on the European Community and on NAFTA.

We shall argue that trade patterns can be based on traditional comparative advantages or on economies of scale. It is to a large extent a matter of policy choice. The trade policies within a trade bloc determine the extent to which the trade bloc will aid or hinder global free trade. The argument for this result, and its implications for trade policy, occupy the rest of this paper.

EC and NAFTA

We now turn to the possible motivation for the United States to form a free trade zone with its neighbors. The argument uses simple strategic considerations based on the results discussed in the previous section. NAFTA—and any further extension to a larger free trade zone in the Americas—can be seen as a strategic response by the U.S. to the creation of the European Community. The European Community is a free trade zone with a quarter of world output. In seeking to form a trading bloc with its natural trading partners in the Americas, the US appears to respond to the creation of more market power, with an attempt to create more market power. This is a rational response if the US expects a united Europe to impose tariffs on the rest of the world. The emergence of a region with increased market power generally provides an incentive to other regions to seek similar status.

More explanatory power still can be extracted from the results of Kennan and Riezman [12][13] and Riezman (1985) on who wins trade wars. Following the creation of a custom union, the incentives are to create or join another free trade zone, but not at random. The economic incentive is to join another free trade zone with the largest possible market power. This result allows us to predict that the US should not only seek a free trade deal with Canada, but one with as many countries in the Americas as possible. The aim is to reach market power which exceeds that of a unified Europe.

Trade Creation and Diversion

Once a new free trade zone is created, how do we measure the gains and losses from trade? A naive view is that since free trade in competitive markets is Pareto efficient, any move towards free trade is positive. As we saw, this would not be correct. We argued that regional trade blocs, being larger than their components, will have more market power and therefore an incentive to impose tariffs against outsiders under traditional conditions. Therefore one of the first negative effects of the formation of a trading bloc is that it can hurt the countries outside these areas. We shall argue below that these negative effects can be mitigated if the trading patterns within the blocs are organized around economies of scale.

But are the damages of free trade zones limited to protectionism with the rest of the world? The answer to this question is generally no. There is a second danger in the formation of regional trade blocs. Even if the trading blocs are not accompanied by increased protectionism against the rest of the world, they can still lead to trade diversion. This means that a regional free trade bloc may lead to the wrong specialization within the bloc. The classical argument about trade diversion is found in Viner (1950), whose work remains a benchmark of analysis of preferential trade agreements. We shall summarize his argument here in order to show that, if trade within the blocs is organized around economies of scale, then Viner's argument breaks down. With economies of scale, the negative effect of trade diversion can be mitigated.

Viner's point is that there are "trade creating" free trade zones, in which the increase in imports by members from one another replaces domestic production. These are desirable. However, free trade blocs could also be "trade diverting" in the case that imports are diverted from a lower cost source outside the bloc to other sources inside the bloc which are less productive, but with more attractive prices after the tariffs were selectively dropped.

The extra trade among the members of the trading bloc is, generally, an improvement of welfare. The trade which is not additional but a diversion from efficient outside sources to less efficient insides sources, lowers welfare. If northern Europe is induced by the entry of southern Europe, to buy oil from Portugal rather than an equivalent from the US, and the US source is more efficient but less competitive after the tariffs are dropped in Europe, there has been a welfare loss. Generally speaking Viner's approach evaluates free trade zones by the extent to which more trade is created, rather than existing trade diverted from one source to another.

Viner's original insight remains central to the analysis of preferential free trade zones. But, in practice, it misses an important aspect. The increase size of the market can sometimes lead to more efficiency and competitiveness. Even in the cases where Viner's analysis predicts welfare losses, namely when the trade bloc diverts trade from outside sources to less competitive inside sources, welfare can still increase with economies of scale.

Economies of scale can therefore have a major impact on trade policies. We shall argue in what follows that they can also limit another major negative effect of a trading bloc: the incentives for large blocs with market power to impose tariffs on others.

What does the empirical evidence show? It is widely believed that economies of scale were an important factor in the success of the Treaty of Rome. Economies of scale were central to the success of the European Common Market which was formed in 1958. While a strong possibility for trade diversion existed a priori in the EC, in reality huge inter-industry trade emerged in manufactures. The increase in market size and the associated rationalization in production led to efficiency gains which took precedence over possible trade diversion. Krugman (1991) discusses this issue in some detail, without however offering a conceptual relation between economies of scale and the economics of trading blocs.

Hopes for large benefits from both the US-Canada free trade agreement and Europe 1992 rest largely on an increase in competition and rationalization. In the North American case, the estimate of Harris and Cox, which attempt to take account of competitive or industrial organization effects, suggest a gain for Canada from free trade that is about four times larger than those of standard models. In Europe the widely cited and somewhat controversial figure of 7 percent gain due to 1992 presented in the Cechini report Commission of the European Communities 1988 rests primarily on estimates by Alisdair Smith and Anthony Venables of gains from increased competition and rationalization.

In practice, therefore, economies of scale can eliminate trade diversion losses, and transform these into gains. I shall also argue below that they can also eliminate incentives for tariff wars between blocs, so that the formation of trading blocs can become a parallel, complementary effort towards the liberalization of world trade.

Part II. Trading Blocs with Economies of Scale

Intra- and Interbloc Trade

Although predictions are inherently dangerous in an area so circumscribed by political action, our conclusion is that regional free trade can have different effects on global markets and it should be to a certain extent the choice of well informed and reasonable economic agents which one will prevail. Regional trading blocs based on traditional comparative advantages will generally divert trade. They will also typically hinder the prospects of global negotiations. In this case, as the bloc has more market power than its parts, it has the incentive to impose larger tariffs on the rest of the world. Regional blocs then develop incentives for imposing tariffs against each other, and for engaging in trade wars. This type of regional free trade zone works against global free trade.

There is, however, an alternative. If the trade blocs expand trade based not on traditional comparative advantages but rather on increased productive efficiency and competitiveness that comes with economies of scale, matters could be quite different. In this latter case, the regional blocs could unleash an appetite for further expansion of trade. We shall argue that in this case the incentive for blocs to impose tariffs against each other is reduced, and in fact can be reversed by economic incentives in favor of trade expansion which accompanies economies of scale. The creation of trading blocs which are organized around economies of scale is therefore part of a broader trend towards increasingly open world markets.

The Americas: Traditional Comparative Advantages or Economies of Scale?

A central issue in our argument is the pattern of intrabloc trade. This issue is of particular importance in an American free trade zone. This is because of all the regions, the American area is the one whose trade is currently based on traditional comparative advantages and on the diversity among the traders' economic development rather than on economies of scale.

The matter is not only one of economic reality; it is also one of perceived economic reality. Both the European and the East Asian countries perceive gains from trade as a matter of exploiting economies of scale. The newly industrialized countries in Asia, and the Japanese, have a dynamic vision of comparative advantages. Moving up the ladder of comparative advantages in the production and trade of skilled labor manufactures, of consumer electronics, and of products based on specialized knowledge and on technological skill, are widespread priorities.

By contrast, within the sphere of influence of the United States, the vision of trade based on traditional comparative advantages still prevails. It permeates to a great extent the thinking about international trade at the government level, at the international organization level, at the academic, and even at the journalist level.

The European free trade zone is, to a certain extent, a zone of equals. To encourage this equality, the introduction of free mobility of labor has been one of the first steps in the European market integration of 1992.

The Americas, on the other hand, have the U.S. as a hegemon, a "hub" which concentrates on exporting manufactures and skill intensive goods to the "spokes" in exchange for their resources. The free mobility of labor between the hub and the spokes is an unspoken issue. It has not even been contemplated in the American negotiations for free trade. It has not been mentioned by any of the governments concerned that labor could move freely between the free trade partners, as it does in the EC region. In some cases, quite to the contrary, the free trade agreement has been mentioned as a way to limit the mobility of labor between the concerned countries.

To the extent that labor remains a fixed input of production within the countries of the American free trade zone, traditional comparative advantages based on labor will be invoked as a foundation for policy. The concern is that an American free trade zone, if it emerges, may reflect the historical patterns of trade between industrial and developing regions, which is usually called North-South trade.

Traditional Comparative Advantages and the Global Environment

Another reason for concern with respect to traditional comparative advantages arises from the current focus on the environment. Traditional comparative advantages emphasize the South's concentration in the production and export of goods which deplete environmental resources, such as wood pulp and cash crops which overuse rain forests, or minerals whose combustion leads to the emission of greenhouse gases. Recent work in the area of North-South trade with environmental inputs to production shows that ill defined patterns of property rights on forests, fisheries, and arable land in developing countries may lead to a market-induced oversupply of goods which are intensive in the use of these resources as inputs, and to Pareto inefficient patterns of international trade. What appears as comparative advantages may simply be a reflection of a market failure in the developing countries. Social and private comparative advantages differ and social and private gains from trade may also differ in these circumstances. Traditional tax policies, levying duties on the use of such inputs in the South, may not work, and may indeed lead to more extraction of the resource and more exports of the resource intensive commodity. Indeed, it is shown in Chichilnisky that differences in property rights on inputs of production are sufficient to explain the patterns of trade between nations.

The environment is another reason for being concerned with traditional comparative advantages as a foundation for trade. Since two thirds of the current exports from Latin America are resources, and the main trade of Ecuador, Venezuela and Mexico with the U.S. is petroleum, this problem is very real. It is also very real with respect to trade in wood products which lead to the deforestation of the remaining tropical forests.[1] Replacing traditional comparative advantages with economies of scale could be a necessary feature of a program of sustainable development.

Skilled Labor and External Economies of Scale

It seems desirable at this point to distinguish an important difference between two types of economies of scale: internal or external to the firm. The former are simply a reflection that each firm may be more efficient in the use of its inputs to production as the level of its output increases. The firm's per unit costs decrease with the level of output. Such economies of scale are typical of industries which require large fixed costs, such as aerospace, airlines, and communications networks. This type of increasing returns, called internal, can lead to monopolistic competition or other forms of limitations to market entry. As such, there is a loss to the consumer in that the free market outcomes are typically not Pareto efficient.

External economies of scale lead to a decrease in per unit costs as the output expands, but they do so at the level of the industry or of the country as a whole. Each firm's production function faces increasing cost per unit of output, i.e. decreasing returns to scale, which assures competitive behavior. However, as the industry as a whole expands, externalities are created which lead to increased productivity for all the firms. A good example is provided by the electronics industry. Each computer manufacturer faces a rather competitive market. On the other hand, as the overall level of output of the industry expands, knowledge about new technologies develops and this new knowledge, which is easily and rapidly diffused across the industry, leads to lower costs for all. Just about any industry which depends heavily on knowledge has this characteristic. In reality, the factor which leads to increasing returns is the skill of the labor force which embodies knowledge. Knowledge is typically diffused and can be captured and imitated sooner or later, and there are abundant examples in the software and hardware industry to prove this point.[2] Knowledge creates skilled labor, and this in turn leads to increasing returns to scale, which usually, although not always, are external to the firm. Because of this skilled labor can simultaneously lead to economies of scale, and to competitive markets. The successful development experience of Korea, of Taiwan, and more recently of the Asian Tigers, shows that export-led policies based on skilled labor intensive goods, for example in consumer electronics, is generally more successful than those intensive in the use of inexpensive and uneducated labor. This point was developed formally in Chichilnisky (1981, 1986) and more recently in terms of development policies in Dadzie (1991).

This paper will concentrate on external economies of scale, which are closely connected with production systems based on skilled labor.

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1. See Amelung (1991), Barbier et al. (1991), Brinkley and Vincent (1990), and Hyde and Neuman (1991).

2. Microsoft's Windows excellent imitation of the Apple operating system was tested in U.S. courts and found without fault.

Optimal Tariffs: Traditional Theory

It was noted above that a large country will typically impose tariffs so as to improve its terms of trade. In doing so it typically introduces distortions in its production and consumption. Here we shall show in a simple example how under traditional assumptions there is a tariff that improves welfare, in the sense that the gains from improved terms of trade exceed the losses from distortions. The analysis is completely standard, see e.g., Krugman and Obsfelt (1988), but it is included here in order to highlight the differences which arise in economies with increasing returns to scale. This is discussed in the next section.

The analysis in this section relies on one assumption and one simplification. Both are relaxed in the Appendix, which considers the general case. The assumption here is that the supply and demand curves of the economy are linear and exhibit decreasing returns to scale, and that there are no major income effects. The simplification is to neglect the impact of the tariff revenues on income; this is typically done in textbooks, and will also be done in this section. It is however explicitly analyzed in the Appendix.

We assume that the home country *H* has a demand curve with equation

$$D = a - b\tilde{p} \tag{1}$$

where $\tilde{p}$ is the domestic price of the good, and a supply curve

$$Q = e + f\tilde{p}. \tag{2}$$

Country H's demand for imports is the difference,

$$D - Q = (a - e) - (b + f)\tilde{p} \tag{3}$$

Foreign export supply is also a straight line,

$$(Q^* - D^*) = g + hp_w, \tag{4}$$

where p_w is the world price. The internal price in country H exceeds the world price by the tariff:

$$\tilde{p} = p_w + t. \tag{5}$$

In a world equilibrium imports must equal exports:

$$(a - e) - (b + f) x (p_w + t) = q + hp_w. \tag{6}$$

Solving equation (6) for $t = 0$ gives p_f, the world price that would prevail without tariffs. Then a tariff t alters the internal price to:

$$\tilde{p} = p_f + th/(b + f + h), \tag{7}$$

and the world price to

$$p_w = p_f - t(b + f)/(b + f + h) \tag{8}$$

Note that if the parameters *a, e, b, h* and *f* are all positive, then

$$p_f < \tilde{p} \text{ and } p_w > p_f, \tag{9}$$

implying that the tariff raises the internal price $\tilde{p}$ and lowers the world price p_w.

It is clear that under these conditions it is always possible to find a tariff t that increases the country's welfare. Let q_1 and d_1 be the free trade levels of consumption and production. Since the internal price is higher after the tariff, domestic supply rises from q_1 to q_2 and demand falls from d_1 to d_2:

$$q_2 = q_1 + tfh/(b + f + h) \tag{10}$$

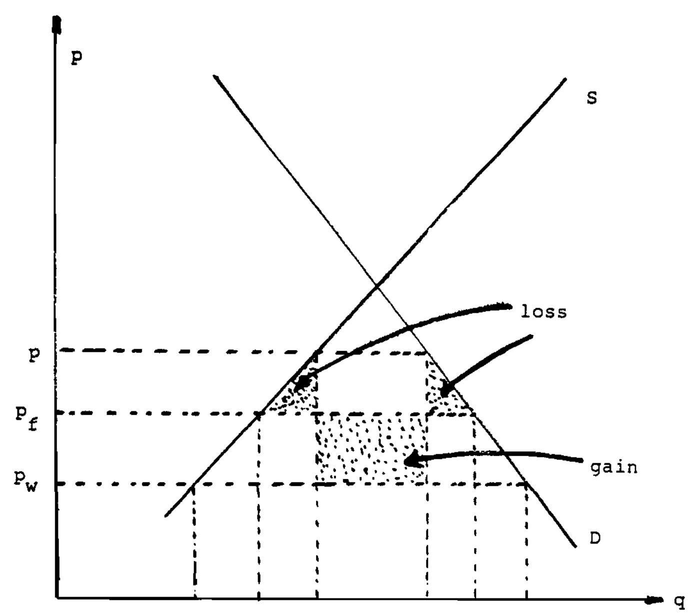
and

$$d_2 = d_1 - tbh/(b+f+h). \tag{11}$$

The gain in welfare from a lower world price is the area of the rectangle in Figure 3, the fall in the price multiplied by the level of imports after the tariff:

$$\text{gain in welfare} = (d_2 - q_2) \times t(b + f)/(b + f + h) =$$
$$t \times (d_1 - q_1) \times (b + f)/(b + f + h) - t^2 \times h(b + f)^2/(b + f + h)^2. \tag{12}$$

Figure 1
Gains and Losses from Tariffs: Traditional Case



The loss from distorted consumption and production is the sum of the areas of the two triangles in Figure 1:

$$\text{loss in welfare} = (1/2) \times (q_2 - q_1) \times (\tilde{p} - p_f) + (1/2) \times (d_1 - d_2) \times (\tilde{p} - p_f) =$$

$$t^2 \times (b + f) \times h^2/2(b + f + h)^2. \tag{13}$$

Therefore the net effect on welfare is

$$\text{gain - loss} = t \times U - t^2 \times V. \tag{14}$$

where U and V are constants. The net effect is the sum of a positive number times the tariff rate and a negative number times the square of the tariff rate. It follows that when the tariff is sufficiently small the net effect must be positive, since t^2 is smaller than t for values of t near zero. This establishes that, when supply and demand are linear, income effects of the tariff income are neglected, and tariffs are small, there exists a positive tariff which increases the welfare of the country beyond that which can be obtained in free trade.

The size of the country matters. If the importing country is small, then foreign supply is highly elastic, i.e., h is very large, so from (8) we verify that the tariff has little or no effect on world prices p_w while raising domestic prices $\tilde{p}$ almost one to one.

Optimal Tariffs with Economies of Scale

The argument in the previous section shows that a large country is better off by imposing tariffs than it is under free trade. This proposition holds under traditional conditions, one of which is that the supply of goods should increase with prices across market equilibria. In our example, this is formalized by the parameters in the supply function in equation (2), which is upward sloping. However, this assumption ceases to be valid with economies of scale. In such economies, the larger is the output the lower are the costs, and therefore, in principle, the lower are the prices. Then $f < 0$ in equation (8), which in turn can lead to a negative welfare gain from the tariff from equation (12).

A good example of this phenomenon is provided by the electronics industry, for example computer hardware. The last fifteen years have seen a dramatic decrease in prices together with a dramatic expansion of output of computer hardware. This occurs because the expansion in output leads to rationalization and the corresponding increased efficiency in production. In the hardware industry this takes the form of technological change which improves productive efficiency and lowers the costs of the industry as a whole. Even though a technological breakthrough may in principle be patented, and therefore could be captured by one firm with the corresponding increase in its market power and deviation from competitive behavior, in practice the computer industry is very competitive. This is because the knowledge which drives the technological innovation in this industry is easily diffused.

A standard textbook analysis of such economies of scale can be found in Nicholson (1978, pp. 252-255), who documents that most studies of long-run cost curves have found that average costs decrease until they become constant. Examples provided are agriculture, electricity generation, railroads, and commercial banking, all activities which are broadly associated with economic development. The same textbook analysis explains how competitive markets can lead to a negative association of quantities and prices across equilibria. This was the content of the famous debate in the 1920s between J. H. Clapham, A. C. Pigou and D. H. Roberston, which was resolved positively, and which appeared in the Economic Journal between 1922 and 1924.[3] Chichilnisky and Heal (1987) discussed in some detail the policy implications of international trade in economies with increasing returns to scale in a report on trade policies in the 1980s to the Secretary General of UNCTAD, and they arrive to similar conclusions.

The analysis of optimal tariffs in the last section breaks down when there are increasing returns to scale. In such economies there may be no gains from imposing tariffs, even if the country is large and has substantial market power. It will be useful to illustrate how this happens in a concrete case. Recall how tariffs increase welfare in the economy of the previous section. Tariffs increase welfare by lowering the world prices p_w: this was seen in equation (7). The country's terms of trade thus improve after the tariff. It imports fewer lower cost goods from the rest of the world. The welfare gains were computed in equation (12), which depend crucially on the fact that, after the tariff, the consumers pay lower prices for the goods they import.

However, this argument no longer holds with economies of scale. With economies of scale the world price may increase rather than decrease after the tariff. The welfare gains from tariffs are the drop in world prices times the quantity imported. But if the world price increases, the gains are transformed into losses.

The possibility that after a tariff the terms of trade deteriorate for the country was studied in Lerner (1936) and in Metzler (1949). They argue mostly in terms of income effects. A similar phenomenon occurs in our economy, but due to different causes. In contrast with the economy of the previous section, the parameter f in equation (8) is now negative rather than positive; this means that across equilibria the prices drop as quantities increase, or otherwise said, price increase when quantities drop. If the tariff decreases the quantity produced and traded, this will lower the productive efficiency of the economy. Costs increase and therefore prices increase too. The tariff defeats the gains from rationalization in production produced by the larger market size. This is represented in Figure 2 below. It shows a negative correlation between market clearing prices and the quantity of goods sold at an equilibrium, and how this leads to an increase in the world prices after the tariff, corresponding to a decrease in output.

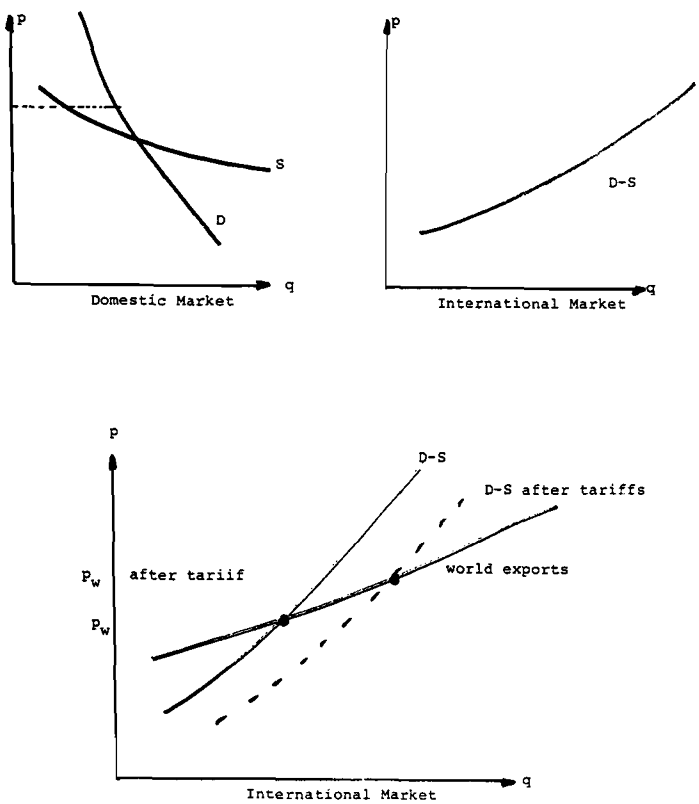
After the tariff, the world price p_w can be higher rather than lower as it is in the traditional case with decreasing returns to scale. The terms of trade for the country are therefore worse after the tariff. Consumers in the country are worse off because the price of their imports have increased. All of this is formally reflected in the systems of equations presented above. In equation (7) the parameter f describing the relation between supply and prices, which was previously positive, is now negative. In practical terms the following conditions are sufficient for the world price to increase rather than decrease after the tariff:

$$\begin{gathered} b < |f| > h \\ f < 0, \text{ and } b \text{ and } h > 0 \end{gathered} \tag{15}$$

3. Nicholson (1978), p. 332.

Figure 2

Losses from Tariffs with Economies of Scale



After the tariff, the world price p_w increases due to economies of scale

These conditions are satisfied under a variety of circumstances. For example (15) holds when foreign export supply increases with, and is highly responsive to, prices ($h > 0$ and large), a reasonable assumption for the world, when the country has increasing returns to scale ($f <$ O) and the quantity produced is more responsive to price than is the demand ($b >$ O, $b < |f|$).

The main condition is the existence of economies of scale in the economy ($f <$ O). Under these conditions, the optimal tariff theorem is no longer true, as the countries may have no economic incentive to impose tariffs on others and they loose by restricting trade.

Consumer electronics, semiconductors, software production, banking and financial services, and just about any sector whose productivity depends mostly on knowledge and information have these characteristics. Software production is today actively developed in India as an export business. It is a sector which is simultaneously labor intensive and subject to informational economies of scale. As already discussed, the remarkable economic development of the Asian Tigers over the last fifteen years profited from the expansion of their international trade of skilled-labor intensive products such as consumer electronics. This sector is simultaneously labor intensive and subject to informational economies of scale.

All the arguments just presented hold equally for countries or for trading blocs. To the extent that sectors with economies of scale expand within the free trade zone, the zone itself loses its economic incentives to use its market power to restrict trade and wage tariff wars against others.

III. Conclusions

The formation of trading blocs typically harms the global liberalization of markets when the blocs are themselves organized under the principle of traditional comparative advantages. Under these conditions, the larger the market power of the bloc the larger are its incentives to impose tariffs on others. Protectionism emerges from the increased market power of the traders.

Retaliation can lead to a tariff war between blocs. Furthermore under traditional assumptions, the larger country wins the tariff war. Therefore the larger the trading bloc, the more likely it is to impose tariffs and to win a trade war.

Trading blocs of this nature have no economic incentive to favor the negotiations under the MTS. They are better off with tariffs than with free trade. Indeed, the economic incentives of such trading blocs are contrary to the GATT's intentions. This explains, to a certain extent, the slow pace of GATT negotiations.

The EC bloc was contrasted with NAFTA or with an eventual American free trade zone. The empirical evidence suggests that the EC trading bloc benefitted from increasing returns to scale.

NAFTA and any eventual WHFTA emerged as a strategic response to the increase market power of the European trading bloc. By contrast with the EC trading bloc, the emerging NAFTA appears to be organizing under the traditional theory of comparative advantage.

The lack of provision for the mobility of labor between the countries of the region reinforces this trend. NAFTA does not contemplate the mobility of labor between Mexico and the U.S. The lack of labor mobility tends to lock in the traditional comparative advantages between the countries within the area. Their trading on the basis of comparative advantages within the bloc will create incentives for trade wars between blocs.

A different scenario contemplates a NAFTA organized around economies of scale. Examples for such scenarios include Indian software trade, and the Asian Tigers' specialization in consumer electronics. Typically, electronic-based industries have increasing returns derived from the creation and diffusion of knowledge as output expands. This leads to rationalization in production and to increased efficiency and thus lower costs. The expansion of output is accompanied by lower rather than higher prices. From the point of view of the exporter, these markets are less likely to be protected because the importer, having increasing returns to scale in this industry, has less incentives to rely on tariffs than it does in other industries with decreasing returns. With increasing returns, tariffs decrease trade and can increase world prices, thus decreasing the welfare of the importing country. Economies of scale produce incentives to expand trade.

The issue is formalized by showing that economies of scale change the standard result of optimal tariffs. While under traditional conditions, a trading bloc is always better off with tariffs than it is with free trade, we showed that with increasing returns to scale this is no longer true. Tariffs decrease the size of the market, and therefore decrease productive efficiency in economies with increasing returns. This decrease in efficiency leads to larger rather than lower world prices, and the main purpose of the tariff, which is to improve the countries' terms of trade, is defeated. Under these conditions trading blocs are better of with free trade, and with the corresponding expanded markets, than they are with tariffs. To the extent that NAFTA organizes itself around economies of scale in the international trade within the region, the incentives for a trade war between NAFTA and the EC are mitigated.

It seems useful to remind ourselves that the choice of products and of technology are to a large extent the subject of policy. They need in no way interfere with market efficiency. The first welfare theorem about the efficiency of competitive markets applies to a market with given technologies and with given products. The theorem does not explain how different technologies or products arise: it proves that once technologies and products are given, competitive markets lead to Pareto efficiency. Once the product mix and the technologies are chosen the market can operate efficiently. This implies that the organizing principles within the blocs—traditional comparative advantages or economies of scale—are, to a great extent, a matter of policy choice. Choosing different trade policies, for example, choosing technologies and the product mix, can be achieved without market distortions or loss of market efficiency. This point was already made by Meade (1971).

The emergence of an American trading bloc which reinforces the current tendency towards the exploitation of traditional comparative advantages is a source of concern. It has been argued in Chichilnisky (1981, 1986, 1987) that export led policies based on (unskilled) labor intensive products can defeat the goals of development and trade by depressing the country's terms of trade and overall consumption. Trade between the countries of the Americas is organized today around traditional comparative advantages: labor and resource intensive exports from the South and capital and skill-intensive exports from the North. If the emergence of a WHFTA is based on similar principles, then not only may this continue a depressing growth trend in Latin America, but in addition it could create or reinforce incentives against the global liberalization of free trade.

We have argued that another reason to avoid trade policies between the countries of the Americas based on traditional comparative advantages is that they tend to deplete environmental assets such as forests, fisheries or fertile land, and overuse minerals which are exported by the developing countries to the North. Some of these minerals are the source of potentially dangerous CO_2 emissions. Petroleum exported from Mexico, Ecuador, and Venezuela to the United States fits this description. Indeed, any concept of sustainable development requires a rethinking of trade policies away from those based on comparative advantages. This general premise is particularly well suited to the NAFTA, and for the Americas as a whole, since two thirds of Latin American exports today are resources.

The main point of this paper is that the characteristics of trading policies within the trading blocs can determine the extent to which the blocs will favor or harm the global negotiations towards free trade. Trading policies based on comparative advantages are generally negative towards the GATT. We argued that trading policies based on economies of scale could have a positive effect towards global free trade: by mitigating the economic incentive of trade restrictions in favor of an expansion of world trade. The emergence of such trading blocs could advance in tandem with the liberalization of world trade.

Appendix: Trading Blocs with Increasing Returns to Scale

This appendix develops an international trade model and proves formally the propositions on customs unions stated in the body of the paper.

The model presented here extends the North-South model introduced in Chichilnisky (1981, 1986, 1987) to the case of economies which trade in goods produced under conditions of increasing returns to scale, and proves formally the proposition that with increasing returns to scale, large countries can achieve higher welfare levels with free trade than with tariffs. This model considers Cobb-Douglas production functions, and it assumes that there exist economies of scale in production which are external to the firm, such as in the example of the electronic industry discussed in the text. The model describes two countries, 1 and 2, producing and trading two goods B (basic goods) and I (industrial goods) with each other; these goods are produced using two inputs, labor (L) and capital (K). The economies of the two countries are competitive, so that in each country prices are taken as given by consumers and producers. Producers maximize profits, and consumers maximize utility subject to their budget constraints. Walras Law is satisfied, so that the value of the excess demand is equal to zero. At an equilibrium, goods and factors markets clear.

The *increasing returns to scale* considered here are "external" to the firm. This means that in the production functions, formalized below, there exists a parameter denoted γ which increases with the level of output of the economy. As the outputs of the economy expand, the production function varies, formalizing the notion that factors are more productive at higher levels of aggregate output. However, the firm takes this parameter γ as given—this is the assumption that the increasing returns are external to the firm. For each given value of the parameter γ the firm has constant returns to scale. The firms are therefore competitive, and in particular zero profits are achieved at an equilibrium.

Consider the model of one country first. The production functions are

$$\begin{aligned} B^s &= \gamma L_1^{\alpha} K_1^{1-\alpha} \\ I^s &= \gamma L_2^{\beta} K_2^{1-\beta} \end{aligned} \tag{16}$$

where α, $\beta \in (0,1)$, γ is a positive parameter, L_1 and K_1 are the inputs of labor and capital in the B sector, and L_2 and K_2 the inputs of labor and capital in the I sector. The total amount of labor and capital in the economy are L^s and K^s, respectively. Prices are p_B and p_I; we assume that I is the numeraire so that

$$p_I = 1. \tag{17}$$

Factor prices are denoted as usual: w for wages and r for rental on capital. We shall assume for simplicity that the demand for basic goods at an equilibrium is known:

$$B^d = \overline{B^d} \tag{18}$$

so that by Walras Law the demand for industrial goods in equilibrium is given by

$$I^d = (wL^s + rK^s - p_B\overline{B^d}), \tag{19}$$

because of zero profits. More general demand functions than those postulated in (18) can be given without a major effect on the results, see for example the various forms of demand functions utilized in Chichilnisky (1986). Indicating the equilibrium level of exports by X_I^{d*}, and the equilibrium level of imports by X_B^{s*}, the model of the world economy is formalized by the following equilibrium conditions:

$$\begin{array}{c} p_B^* B^{s*} + I^* = w^* L^* + rK^* \text{)(zero profits)} \\ K^* = K^s = K_1 + K_2 \text{ (capital market clears)} \\ L^* = L^s = L_1 + L_2 \text{ (labor market clears)} \\ B^{s*} = B^{d*} + X_B^{s*} \text{ (} B \text{ market clears)} \\ I^{d*} = I^{s*} + X_I^{d*} \text{ (} I \text{ market clears)} \end{array} \tag{20}$$

Solving the Model

The model for the world economy consists of two countries, indicated with the indices 1 and 2, each specified as above. To solve the model, there are therefore five prices to be determined: the "terms of trade" p_B, and two factor prices in each country, w and r. The quantities to be determined in an equilibrium are: the use of factors in each sector of each country: K_l, K_2, L_l, L_2, the outputs of the two goods B^s and I^s, and the corresponding parameter γ determining the external economies of scale, the exports and imports of each of the two goods in each of the two countries, X and X , and the demand for each good in each country, B^{d*} and I^{d*}. There is a total of *27 variables* to be determined endogenously, including all prices and quantities in all markets and both countries.

In the following proposition 1 we shall prove that all of these variables can be determined once the variable giving the terms of trade in equilibrium p_B is known. Further, we shall prove that there exists *one* "resolving equation" that determines the equilibrium value of the terms of trade as a function of all the exogenous parameters of the model, of which there are six in each country: α, β, σ, B^{d*}, L^s and K^s, and a total of 12 in the world economy.

The Effects of a Tariff on Terms of Trade

Proposition 1: *If the importing country 1 has external economies of scale,*

$$\gamma = \gamma B = B^\sigma, \ \sigma > 1$$

and the foreign supply is highly elastic ($\partial X_B^{s,2} / \partial p_B > 0$ and very large) then no tariff can increase the welfare of the country relative to that which the country can achieve under free trade.

Proof:

Consider a world economy with two countries defined as in equations (16) (17) (18) (19) (20). We shall now solve the model by finding an explicit expression for the equilibrium terms of trade p_B^* in the world economy. This consists of writing the market clearing conditions in the B market, exports equal imports, and expressing it as a function of one variable: p_B. From the terms of trade in equilibrium, we show that all other endogenous variables can be found. We shall use the indices 1 and

2 to distinguish the parameters of the two countries. Note first that we have given no specification of demand or supply behavior outside of an equilibrium; in particular, there is no information for carrying out stability analysis. Since the model has constant returns to scale, profit maximizing supply functions are, as is standard, undefined. As is standard in models with constant returns to scale, we derive the equilibrium relations between supplies and prices from the condition of full employment of factors together with an equilibrium condition which incorporates the external economies of scale.

Denote:

$$l_l = L_l/K_l$$
$$l_2 = L_2/K_2$$

Since by assumption each firm takes the parameter γ as given, from the production functions (16), marginal conditions and zero profits imply:

$$\begin{aligned} w &= \gamma\alpha(L_1/K_1)^{\alpha-1}p_B = \gamma\alpha l_1^{\alpha-1}p_B \\ r &= \gamma(1-\alpha)l_1^{\alpha}p_B \\ w &= \gamma\beta l_2^{\beta-1} \\ r &= \gamma(1-\beta)l_2^{\beta} \end{aligned} \tag{21}$$

so that

$$\frac{r}{w} = [\frac{(1-\alpha)}{\alpha}]l_1 \text{ and } \frac{r}{w} = [\frac{(1-\beta)}{\beta}]l \tag{22}$$

and in particular

$$l_1 = \frac{[(1-\beta)\alpha]}{[\beta(1-\alpha)]}l_2. \tag{23}$$

The next step is to define an equation (called the "resolving equation" and denoted $F = 0$) which yields the equilibrium value of the terms of trade p_B as a function of all the exogenous parameters of the model of which there are 12 as listed above, and from which all other endogenous variables at equilibrium are explicitly computed.

Indicating logarithms with the symbol " $\sim$ ", the four equations in (21) can be rewritten as:

$$\begin{aligned} \tilde{w} &= (\alpha-1)\tilde{l}_1 + \tilde{\alpha} + \tilde{p}_B + \tilde{\gamma} \\ \tilde{r} &= \alpha\tilde{l}_1 + \widetilde{(1-\alpha)} + \tilde{p}_B + \tilde{\gamma} \\ \tilde{w} &= (\beta-1)\tilde{l}_2 + \tilde{\beta} + \tilde{\gamma} \\ \tilde{r} &= \beta\tilde{l}_2 + (1-\beta) + \tilde{\gamma}. \end{aligned} \tag{24}$$

so that

$$\begin{aligned} (\alpha-1)\tilde{l}_1 + \tilde{\alpha} + \tilde{p}_B &= (\beta-1)\tilde{l}_2 + \tilde{\beta} \\ \alpha\tilde{l}_1 + \widetilde{(1-\alpha)} + \tilde{p}_B &= \beta\tilde{l}_2 + \widetilde{(1-\beta)} \end{aligned} \tag{25}$$

or, equivalently,

$$(\alpha-1)\tilde{l}_1+(1-\beta)\tilde{l}_2=\tilde{\beta}-\tilde{p}_B-\tilde{\alpha}$$
$$\alpha\tilde{l}_1-\beta\tilde{l}_2=(\widetilde{1-\beta})-\tilde{p}_B-(\widetilde{1-\alpha}). \tag{26}$$

Solving for $\tilde{l}_1, \tilde{l}_2$ gives:

$$\tilde{l}_1=\frac{[(\tilde{\beta}-\tilde{p}_B-\tilde{\alpha})(-\beta)-(1-\beta)[(\widetilde{1-\beta})-\tilde{p}_B-(\widetilde{1-\alpha})]}{[\beta-\alpha]}- \tag{27}$$

and

$$\tilde{l}_2=\frac{[(\alpha-1)[(\widetilde{1-\beta})-\tilde{p}_B-(\widetilde{1-\alpha})]-[(\tilde{\beta}-\tilde{p}_B-\tilde{\alpha})\alpha]]}{[\beta-\alpha]}. \tag{28}$$

From (27) and (28) we obtain:

$$\tilde{l}_1=\frac{\tilde{p}_B}{(\beta-\alpha)}+A \tag{29}$$

and

$$\tilde{l}_2=\frac{\tilde{p}_B}{(\beta-\alpha)}+B$$

where

$$A=\frac{[(\tilde{\beta}-\tilde{\alpha})(-\beta)-(1-\beta)[(\widetilde{1-\beta})-(\widetilde{1-\alpha})]]}{(\beta-\alpha)},$$

and

$$B=\frac{[(\alpha-1)[(\widetilde{1-\beta})-(\widetilde{1-\alpha})]-\alpha(\tilde{\beta}-\tilde{\alpha})}{(\beta-\alpha)},$$

$A > 0$ and $B < 0$ if $\beta < \alpha$. Therefore,

$$l_1=e^{A}p_B^{1/(\beta-\alpha)} \tag{30}$$

and

$$l_2=e^{B}p_B^{1/(\beta-\alpha)}.$$

Now,

$$l_2 = \frac{(L^s - L_1)}{K^s - K_1} \Rightarrow L^s - L_1 = l_2(K^s - K_1) \text{ or } L_1 = L^s - l_2(K^s - K_1) \tag{31}$$

and

$$l_1 = L_1/K_1 \Rightarrow L_1 = l_1K_1 \text{ so that } L^s - l_2(K^s - K_1) = l_1K_1 \tag{32}$$

$$\text{or } K_1(l_1 - l_2) = L^s - l_2K^s \Rightarrow K_1 = (L^s - l_2K^s)/(l_1 - l_2). \tag{33}$$

From (13), (32), and (33) we obtain:

$$K_1 = \frac{(L^s - l_2K^s)}{(l_1 - l_2)} \tag{34}$$

and

$$L_1 = \frac{(l_1)}{(l_1 - l_2)}(L^s - l_2K^s) \tag{35}$$

which together with (30) gives the levels of supply of labor and capital used in each sector, at an equilibrium as a function of the equilibrium level of the relative price of B:

$$L_1 = \frac{e^A L^s}{(e^A - e^B)} - \frac{e^A e^B}{(e^A - e^B)} K^s p_B^{1/(\beta-\alpha)} \tag{36}$$

and

$$K_1 = \frac{L^s}{e^A - e^B} p_B^{1/\alpha-\beta} - e^B(e^A - e^B)K^s \tag{37}$$

Expressions (16) and (36) give the quantity of B and I produced at each level of relative prices, p_B. Now taking $\gamma = 1$, we denote these as $\phi(p_B)$ and $\psi(p_B)$, respectively. Therefore from (16) we obtain the equilibrium level of outputs as a function of equilibrium prices:

$$B^s = \gamma\phi(p_B) \tag{38}$$

and

$$I^s = \gamma\psi(p_B).$$

Note that this does not fully express outputs as an explicit function of equilibrium prices because $\gamma = \gamma(B)$. To obtain outputs as explicit functions of equilibrium prices we must also find out the equilibrium value of $\gamma = \gamma^*(B)$, which is a "fixed point" problem, since γ depends on B and B depends on γ. This is solved as follows.

The economy has increasing returns which are external to the firm, and the parameter γ increases with the level of output of B and I:

$$\gamma = B^{\sigma}. \tag{39}$$

At an equilibrium, equations (38) and (39) must be satisfied simultaneously, i.e.,

$$\begin{aligned} \gamma &= [\gamma\phi(p_B)]^{\sigma} \\ &= \gamma^{\sigma}\phi(p_B)^{\sigma}, \text{ or } \gamma^{1-\sigma} = \phi(p_B)^{\sigma} \end{aligned} \tag{40}$$

so that

$$\gamma = \phi(\mathrm{p_B})^{\sigma/(1-\sigma)}.$$

Therefore at an equilibrium from (38) we obtain a relation between the outputs of B and I, and p_B:

$$\begin{aligned} B^s &= \phi(p_B)^{\sigma+1/(1-\sigma)} \\ I^s &= \psi(p^B)^{\sigma+1/(1-\sigma)} \end{aligned} \tag{41}$$

Note that when $\sigma > 1$, $\theta = \sigma + 1/1\text{-}\sigma < 0$ so that when $B^s = \phi(p_B)^{\sigma+1/(1-\sigma)}$ decreases with p_B across equilibria, since $\phi(p_B)$ is an increasing function of p_B for each fixed γ, see Figure 3.

If $\alpha \rightarrow 1$, $\theta \rightarrow -\infty$.

To solve the model we now consider the market clearing condition in B. At a world equilibrium, the B market must clear so that:

$$B^{d,1}(p_B + t) - B^{s,1}(p_B + t) = B^{s,2}(p_B) - B^{d,2}(p_B), \text{ or}$$

$$F(p_B, t) = B^{d,1}(p_B + t) - B^{s,1}(p_B + t) - B^{s,2}(p_B) + B^{d,2}(p_B) = 0. \tag{42}$$

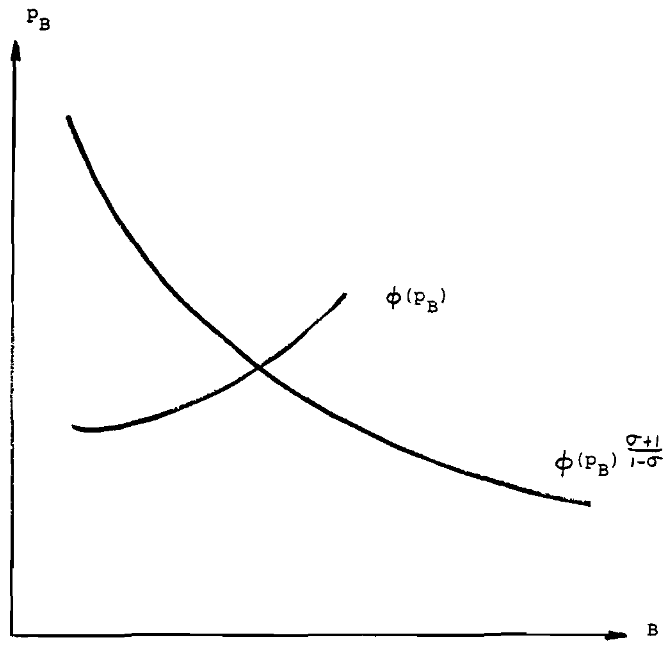
From (18) (19) (21) (30) and (41), equation (42) is a function of the variable p_B alone, which we call a reduced form "resolving" equation for this model. Solving this equation gives the equilibrium values of p_B from where all other variables can be computed as shown above. The model is thus solved.

We may now study the changes in the terms of trade as a function of the tariff t. By the implicit function theorem:

$$\begin{aligned} \partial p_B/\partial t &= \frac{-\partial F/\partial t}{\partial F/\partial p_B} \\ &= \frac{-(\partial(B^{d,1} - B^{s,1}/\partial(p_B + t)}{\partial B^{d,1}/\partial(p_B + t) + \partial B^{d,2}/\partial p_B - \partial B^{s,1}/\partial(p_B + t) - \partial B^{s,2}/\partial p_B} \end{aligned} \tag{43}$$

By the assumptions on demand for B, if $\sigma_1 > 1$, then $\delta B^{s,1}/\delta(p_B + t) < 0$ and therefore the numerator of (43) is negative. The denominator is also negative, so that $\delta p_B/\delta t > 0$. As the tariff t increases, p_B also increases. The terms of trade of the country decrease, since it imports B and must now pay more for it, as we set out to prove.

Figure 3



Each firm faces an upward cost curve. The country as a whole faces a downward cost curve due to external economies of scale.

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III. Key Negotiating Issues

RULES OF ORIGIN IN A WESTERN HEMISPHERE FREE TRADE AGREEMENT

N. David Palmeter

Introduction

The purpose of a free trade area is to confer a tariff preference to the products of its members, and rules are needed to determine what products are entitled to the preference. These "rules of origin," as they usually are called, provide the legal basis for determining the "nationality" of a product — whether it "originates" in the territory of a member of the free trade area for purposes of the preference.

When goods are produced entirely within the territory of a member of the area, for example, an agricultural product, origin is clear. But when materials imported from outside the area are incorporated in an article produced within the area, difficult questions can and do arise. If countries A and B have established a free trade area, an article produced in country C will not be given duty free treatment by A simply because it has been transshipped to A through B. Something must be done in B to transform the article from C into a product of B. Rules of origin are used to establish what that "something" is.

Since free trade areas confer tariff preferences only on the products of their members, they also, of necessity, discriminate against the products of nonmembers. A more accurate term for a "free trade" area would be "preferential trade" area. Similarly, a more accurate term for "rules of origin" would be "rules of preference" because these rules are used to determine origin for purposes of the preference only. When it is necessary to determine origin for other purposes, different rules generally are used.

In the United States the rules used to determine origin for most-favored nation (MFN) tariff rates and for country-of-origin marking purposes are different from the rules used to determine origin under the Generalized System of Preferences; these rules differ from those used in the Caribbean Basin Initiative, and all of them are different from the rules used to determine origin in antidumping proceedings. Still other rules of origin are used to determine eligibility for government procurement. Rules of origin in the U. S.-Israel Free Trade Area (USIFTA), the Canada-U.S. Free Trade Agreement (CUSFTA), and the proposed North America Free Trade Agreement (NAFTA) differ from each other and from all other U.S. rules of origin. Thus, the fact that an article "originates" in a particular country under FTA rules does not necessarily mean that it originates in that country for other purposes.

The first part of this paper examines different rules or methods used to determine origin. The second part surveys the rules used in a variety of preferential trade blocs. Harmonization of rules of origin are the subject of the third section, and the fourth section addresses policy issues that arise in the context of rules of origin. The final section summarizes and concludes the paper.

Methods of Determining Origin

Various rules or methods are used to determine origin, and each method has advantages and disadvantages; none has proved to be totally satisfactory. Adoption of one particular rule of origin simply amounts to acceptance of one set of shortcomings over others. Some rules of origin, however, have fewer shortcomings than others.

Change in Tariff Heading

Under a rule based on change in tariff heading, or CTH, an article completed in one country from materials originating in another will be deemed to originate in the country of completion if the processing there is sufficient to change the tariff classification of the imported materials to a specified degree.

CTH appears to be the "wave of the future" in rules of origin, at least for international agreements. It was the basis of the proposal by the United States to the General Agreement on Tariffs and Trade (GATT) to relax international rules of origin, and it was largely accepted in the Uruguay Round negotiations.[1] It is the basis of the rule used in the CUSFTA, the NAFTA, and the *Mercado Común del Sur* (MERCOSUR).

Rules of origin in the CUSFTA and NAFTA are set out in terms of the widely used Harmonized Commodity Description and Coding System (harmonized system or HTS), which classifies articles at a two-digit chapter level, a four-digit heading level, a six-digit subheading level, and an eight-digit statistical level.

The case of tomato catsup and tomato paste offers an example. Catsup is classified in chapter 21 of the HTS, under item 2103.20, while tomato paste is classified in chapter 20, under HTS item 2002.90. The CUSFTA rule of origin provides that the operations necessary to convert a product classified in any chapter other than chapter 21, into a product classified in that chapter, will confer preferential origin on the chapter 21 product. Thus, tomato catsup (chapter 21) produced from imported tomato paste (chapter 20) originates where the catsup is produced for CUSFTA preference purposes.

Under NAFTA, however, the rule is different. Conversion of tomato paste imported from outside NAFTA into tomato catsup within NAFTA will not confer origin on the catsup for preferential purposes. The formulation of the rule is that a change to item 2103.20 (tomato catsup) from any other chapter, except subheading 2002.90 (tomato paste) will confer origin. Thus, if fresh tomatoes (item 0702) are converted to tomato paste within NAFTA, and the paste then is made into catsup, also within NAFTA, the catsup would qualify for the preference; but if the paste is imported, the preference for catsup will be denied.

1. N. David Palmeter, "The U.S. Rules of Origin Proposed to GATT: Monotheism or Polytheism?", 24 *Journal of World Trade* No. 2, p. 25, (April 1990); Edurne Navarro, "Rules of Origin in GATT" in Bourgeois, Vermulst, and Waer (Eds.), *Rules of Origin in International Trade: A Comparative Study* (University of Michigan Press 1993).

These two rules demonstrate some of the advantages and some of the disadvantages of the CTH system. Among the advantages is the fact that once a rule is decided, it can be stated clearly and unambiguously, and it is easy for those in the trade to learn. The disadvantage lies in the method by which the substance of the specific rule is decided. Under CTH as it is used in the CUSFTA and NAFTA, there is no single "rule" of origin, such as a rule that states that any change at the two-digit, or the four-digit, or the six-digit level will confer origin. The CUSFTA and the NAFTA use change at all of these levels (and also at the eight-digit level) to determine origin, depending upon the product. Instead of a general rule or principle of origin, there are hundreds of individual rules in each of the agreements.[2] Thus, CTH is the method used to determine origin of catsup in both the CUSFTA and the NAFTA, but the specific rules for catsup in the two pacts are different.

This absence of a general rule or principle for determining origin is perhaps the major shortcoming of CTH, one that would be no surprise to political realists or to economists of the public-choice persuasion. It renders CTH susceptible to capture by industries interested in minimizing their exposure to competition. In NAFTA, in the case of tomato catsup it was apparently easy for an industry interested in minimizing competition from tomato paste outside the three-country area to fashion a product-specific rule denying the preference to catsup made from the imported tomato paste. There is no other apparent reason for the change in NAFTA from the CUSFTA rule. In 1992, Chile was the leading foreign supplier of tomato paste to the United States. Thus, Chilean tomato paste can be used in catsup that will enjoy preferential treatment under the CUSFTA, but none of it will have that privilege under NAFTA. Mexico was the second leading supplier of tomato paste to the U.S. in 1992.[3]

These facts would seem to justify the tentative assumption that the rule was changed at the behest of the Mexican producers of tomatoes or tomato paste, who presumably would benefit at the expense of their competitors in Chile. But this assumption depends upon further assumptions, such as the assumption that most tomato catsup in NAFTA is made outside Mexico, that the MFN duty rate in Mexico for catsup is significant compared to the advantages the NAFTA preference would offer, and that the Mexican market is important to the catsup producers in Canada and the United States. Otherwise, Canadian and U.S. producers of catsup might not find the NAFTA benefits significant enough to switch from their current Chilean suppliers of tomato paste.

The very fact that we are able only to speculate about the "policy" behind this particular rule illustrates the ease with which CTH may be captured by specific companies or industries. The stated rules are, superficially, comprehensible to all, but their rationale rarely is. The rules of origin for tomato catsup in the CUSFTA and the NAFTA are stated clearly and unambiguously, but the rationale is

2. By one count, the CUSFTA contains 1,498 separate rules of origin spread among the 20 pages of the revelvant annex to the FTA. See David Palmeter, "The FTA Rules of Origin: Boon or Boondoggle?" in Dearden, Hart, and Steger (Eds.) *Living With Trade: Canada, The Free Trade Agreement, and the, GATT*, pp. 41, 47 (Institute for Research on Public Policy and Centre for Trade Policy and Law, Ottawa, 1989). There appears to be no public count of the number of separate rules of origin in the NAFTA, but the number of pages in the relevant annex (Annex 401) listing the specific rules is 148 (pp. 3-150). Extrapolation would suggest, therefore, that the number is in excess of 11,000.

3. In 1992, according to statistics published by the U.S. Department of Commerce, the United States imported 22,112 metric tons of tomato paste, 8,754 (39.6% of the total) from Chile and 6,634 (30.0%) of the total from Mexico.

apparent for neither. And while we may speculate, we do not know and probably would have difficulty learning the rationale for the change.

Tariff schedules are lengthy, complex, and tedious. A section of a tariff schedule usually will be comprehensible only to those familiar in detail with the products, processes, and economics of the industry. The hundreds of pages and thousands of lines of a tariff schedule offer countless opportunities for similar rules, rules that sometimes may amount to a covenant not to compete. A well-known example from the CUSFTA is the rule that the production of aged cheese from fresh milk does not confer origin.[4] This rule suggests that elements of the Canadian and American dairy industries agreed to stay on their own sides of the border, hardly a "free" trade stance. NAFTA has become notorious for rules of this kind:

> ...NAFTA contains a catalog of special-interest measures. It is a free-trade agreement, perhaps, but one full of protectionism for certain companies. Through special domestic-content regulations known as rules of origin, for instance, General Motors Corporation would get a leg up on Honda Motor Company in Mexico. U.S. textile makers would be able to shut out India's market. Zenith would be able to use changes in tariff rules to check incursions by low-cost Korean imports.[5]

CTH, as noted above, is not, accurately speaking, a "rule" of origin or preference; rather, it is a "method" for establishing rules of origin or preference. By itself, it is neutral, neither desirable nor undesirable as a trade policy instrument. Desirability depends upon the hundreds, even thousands, of individual rules that are established and their effectiveness in achieving trade policy goals.

CTH also presumes that origin can be determined by a quick glance at the tariff schedule. Very often this will be the case. The rule for tomato catsup is clear, even if its rationale is not. But sometimes a glance at the tariff schedule will not produce a clear answer because it is not always apparent where in the tariff schedule a particular item should be classified. Tariff classification disputes have been a mainstay of the practice of customs lawyers for generations. They are likely to continue to be a source of dispute and work for lawyers, as attested by the well-known controversy in the United States over the

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4. Canada-U.S. Free Trade Agreement, 27 *International Legal Materials* 281, Annex 301.2. Section 1 of Annex 301.2 requires a change at the chapter level of the Harmonized System to confer origin; changes within chapters will not suffice. All dairy products are included within a single chapter, Chapter 4, of the Harmonized Tariff Schedule. Consequently, the origin of manufactured dairy products such as cheese, always will be the country in which the milk was produced, regardless of where the cheese was made. Indeed, as the rule is written, fresh milk is not considered substantially transformed for FTA purposes even if a magician could change it into bird's eggs or honey, since these too, are included in Chapter 4.

5. Bob Davis, "Sweetheart Deals—Pending Trade Pact with Mexico, Canada Has a Protectionist Air," *Wall Street Journal*, 22, July 1992, p. 1.

question of whether imported minivans should be classified as passenger cars or as trucks.[6] CTH is not, therefore, completely free from subjective or political influences in its application.

Another problem with CTH is its tendency to become outdated if the underlying tariff schedule is not kept current. When dealing with a particular product area, tariff schedules usually specify the major products within the area, and then provide a "basket" heading for all other related products. In rapidly developing product areas there is a tendency for the trade to move into the basket category as newly developed products replace those listed in the schedule. This problem can be remedied by keeping the tariff schedule up to date, but if the tariff schedule involved requires international negotiation, this may not always be easy. What industries in one country may see as "updating," industries in another may see as a threat. It seems unlikely that any significant change would be made in a tariff schedule without the concurrence of the industries concerned, effectively giving a veto to those who believe they would face increased competition as a result of the change.

Finally, CTH can be burdensome and expensive. For example, producers who wish to take advantage of the free trade agreements between the European Communities and the individual European Free Trade Area (EFTA) countries, which are based on CTH, must maintain records establishing the tariff classification not only of finished products but also of all raw and intermediate materials imported from third countries. The costs of the border formalities needed to administer this system have been estimated to amount to at least three percent of the value of the goods concerned, while the total economic cost has been estimated to amount to at least five percent of that value. This burden is enough to lead exporters of up to 25 percent of presumably eligible trade to forego the preference and simply pay the MFN duty.[7] Anecdotal evidence suggests the phenomenon of exporters declining the preference to avoid the paperwork also occurs in FTA trade.[8]

Value Added

The requirement that a minimum value be added to imported materials to confer origin for the finished product on the importing country may be employed as a separate rule of origin or in conjunction

6. See "Japan Official Blasts Push to Raise Minivan Tariff," *Wall Street Journal*, 9 March 1993, Section B, p. 6; "Welfare Compromise for Auto Makers," *New York Times*, 18 February 1993, Section A, p. 22; "Japan Threatens to Go to GATT If U.S. Boosts Minivan Tariffs," *Journal of Commerce*, 17 February 1993, Section A, p. 3; "Bill Would Increase Tariffs on Mutipurpose Vehicle Imports," 9 *International Trade Reporter* (BNA) 1126, 1 July 1992; "When is a Truck?," *Washington Post*, 22 Feb. 1989, p. A16, col 1; "If It Quacks Like a Truck, It is a Truck," *Washington Tariff & Trade Letter*, 20 Feb. 1989, p. 3; another example, in the context of the FTA, is sweeteners. *See*, "Canadian Sugar Refiners Voice Opposition to U.S. Customs Tariff Change on Sweeteners," 6 *International Trade Reporter* (BNA) 176, 8 Feb. 1989.

7. Jan Herin, "Rules of Origin and Differences Between Tariff Levels in EFTA and in the EC," European Free Trade Association, Occasional Paper No. 13.

8. See, e.g., G. Pierre Goad, "The new hat trick: figuring out the country of origin isn't worth the trouble," *Wall Street Journal*, 24 September 1992; "Certification documents, rules of origin highlight business frustration with FTA," 7 *International Trade Reporter* (BNA) 911, 20 June 1990; "Complicated rules of origin set by FTA discourage exporters, GM official says," 6 *International Trade Reporter* (BNA) 1355, 18 October 1989. These examples also referred to the complexity of value-added requirements, which are often used along with CTH.

with another rule. Because processing and assembly often do not result in meaningful tariff changes, value added is often used to supplement CTH when parts and components are assembled into a final product. The Canada-U.S. FTA, NAFTA, and MERCOSUR are free trade agreements with CTH rules of origin supplemented by value added.

Like CTH, value added has the advantage of being a rule that may be stated plainly and unambiguously but, like CTH, value added may also be more certain in its statement than in its application. While CTH is subject to capture by special interests, value added may avoid capture by anyone, including governments, and that too can be a problem.

The statement of a value added "rule" is simple: for example, 50 percent of the value must be added in a country before origin will be conferred on that country. But calculation of value added frequently depends upon resolution of complex and controversial accounting issues. This adds both cost and uncertainty. Lengthy and costly audits are an inherent part of any rule based on value added since the claims of exporters must be verified. These impose a continuing administrative cost well beyond that which prevails with other rules of origin. Uncertainty is heightened under a value-added system because origin is never finally determined until audits are completed, and that can take years. If the auditors disagree with the calculations of the parties, enormous, unexpected demands for payment of duties may result.[9] Whatever else value added may be as a rule of origin, certain and efficient it is not.

Perhaps most important, under value-added rules origin may change in unpredictable and uncontrollable ways that avoid "capture" even by governments. Origin may change from one day to the next because of fluctuations in exchange rates or in costs of materials. Moreover, operations that confer origin when performed in one country may not do so when performed in another because of different labor costs. In NAFTA, for example, origin—and preference eligibility—will be conferred more easily under value added on higher-wage Canadian and U.S. operations than on lower-wage Mexican operations. In this way a value added rule may distort economic efficiencies and divert investment from where it might otherwise occur.[10]

9. Value added was the source of the "Honda Controversy" between Canada and the U.S. under the origin rules of the FTA. *See,* David Palmeter, "The Honda Decision: Rules of Origin Turned Upside Down," 32A *Free Trade Observer* (CCH Canadian) June 1992.

10. NAFTA provides that value added may be calculated on the basis of either a transaction value method or a net cost method.

Transaction value method:

$$RVC = \frac{TV - VNM}{TV} \times 100$$

where RVC is the regional value content, expressed as a percentage; TV is the transaction value of the good adjusted to a F.O.B. basis; and VNM is the value of non-originating materials used by the producer in the production of the good.

Net cost method:

Specified Process

Under a specified process system, rules are drawn in terms of particular industrial operations. The system shares with CTH the advantages of a clear and unambiguous statement of individual rules, but it also shares with CTH the problem of obsolescence, as technical developments may tend to overtake the texts of specific rules. More important, specified process shares with CTH a susceptibility to capture by industries that may not always view trade expansion as a worthy goal.

When governments base rules on the details of industrial processes, the industries concerned are likely to have a major influence in the formulation of these rules. Industries, after all, will have more expertise than governments in their own processes. For example, since 1984 the United States has used a specified process system for its textile rules of origin. These rules are widely perceived to have been driven by the protectionist interests of the textile and apparel industries in the U.S.[11] The NAFTA rules of origin for textiles and textile products implement many of the 1984 U.S. textile rules of origin. Indeed, the NAFTA rules for textiles and apparel are even more restrictive than the 1984 U.S. rules.

Specified process rules are dissimilar to CTH rules in at least one important respect. They are not based on an agreed set of descriptions, such as a common tariff schedule. They are therefore likely to be even more difficult to negotiate in a multilateral context. To the extent that specified process rules of origin are used in free trade agreements, they seem to be used (as in NAFTA) primarily as a supplement to other rules.

Substantial Transformation

The basic rule of origin used in the United States is the "substantial transformation" rule. Strictly speaking, all rules of origin are substantial transformation rules—the substantiality of a transformation is defined by change in tariff heading, or by value added, or by specified processes. As the term "substantial transformation" is used in the U.S., however, it has come to mean the determination of origin case by case, a methodology congenial to common-law legal systems. Its advantages are those of

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$$RVC = \frac{NC-VNM}{NC} \times 100$$

where RVC is the regional value content expressed as a percentage; NC is the net cost of the good; and VNM is the value of non-originating materials used by the producer in the production of the good. North American Free Trade Agreement, Art. 402.2.

11. Craig R. Giesse and Martin J. Lewin, "The Multifiber Arrangement: 'Temporary' Protection Run Amuck," 19 *Law and Policy in International Business* 51, 129 ff. (1987); N. David Palmeter, "Rules of Origin or Rules of Restriction? A Commentary on a New Form of Protectionism," 11 *Fordham International Law Journal* 1, 26 (1987).

that system: the slow, incremental development of the rule built upon its application to specific factual situations, reasoning from one case to the next.[12]

By building upon precedent, reasoning by analogy, and taking one step at a time, such a system can establish sound, predictable rules. Nevertheless, the system has been criticized in the United States as inherently imprecise and subjective.[13] This debate, however, is irrelevant to the question of a rule of origin for a WHFTA. Regardless of whether the substantial transformation system works well within a particular national legal system, it would be difficult to use as an international standard. In the Western Hemisphere, only Canada and the United States use the common law system, and even they did not use substantial transformation as the rule of origin in their FTA. A substantial-transformation rule based on the common-law case method will succeed only if there is, at the top of the system, a court charged ultimately with deciding appealed cases and creating the case law upon which the system depends. No such international court exists, nor is one likely to be established for a free trade area. Consequently, substantial transformation is likely to be unworkable as a rule of origin for a free trade area.

Examples of Rules of Origin in Free Trade Areas and Customs Unions

Andean Group

The signatories to the Cartagena Agreement, establishing the Andean Group (Bolivia, Colombia, Ecuador, Peru, and Venezuela) have established rules of origin based on CTH, supplemented generally by a 50-percent value-added rule.[14]

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12. As explained by one of the leading legal scholars in the U.S.:

> It is a three-step process described by the doctrine of precedent in which a proposition descriptive of the first case is made into a rule of law and then applied to a next similar situation. The steps are these: similarity is seen between cases; next the rule of law inherent in the first case is announced; then the rule of law is made applicable to the second case.

Edward H. Levi, *An Introduction To Legal Reasoning* (Chicago: University of Chicago Press, 1949), pp. 1-2.

13. John P. Simpson, "Reforming Rules of Origin," *Journal of Commerce*, Oct. 4, 1988, p. 12A, col. 2.

14. Andean Group, Commission Decision 293 — Special Norms for Determining the Origin of Goods (March 21, 1991) 32 *International Legal Materials* 172 (1993). The value added rule specifies that "In the case of Bolivia and Ecuador this percentage shall be 60 percent." Article 1(e). It is not clear from this translated text whether goods *from* Bolivia and Ecuador shall be subjected to this higher amount, or whether Bolivia and Ecuador may apply this higher amount to goods from other members of the Group.

ASEAN Free Trade Area

The 1992 Agreement on the Common Effective Preferential Tariff (CEPT) scheme for the ASEAN Free Trade Area provides that a product shall be deemed to be originating from ASEAN Member States if at least 40 percent of its content originates from any member state.[15]

Australia-New Zealand CER

The 1983 Australia-New Zealand Closer Economic Relationship (CER) relies on a 50 percent value added standard. It also requires that the last process performed in the manufacture of the goods involved be performed in the territory of the exporting member state.[16]

Canada-U.S. Free Trade Agreement.

The primary rule of origin in the Canada-U.S. Free Trade Agreement is change in tariff heading. This is supplemented by a 50-percent value-added test for many products.[17]

European Communities Association Accords

The EC has a variety of preferential trade arrangements which may be considered regional, such as the agreements with the countries of the European Free Trade Area (EFTA), the African, Caribbean and Pacific Countries (ACP), the Mashreq countries (Egypt, Jordan, Lebanon, and Syria) and the Magreb countries (Algeria, Morocco, and Tunisia). The rules of origin vary somewhat from agreement to agreement, but in general they are based on CTH supplemented by specified processing requirements and, in some cases, value added.[18]

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15. Fourth ACP-EEC Convention, Protocol 1 Concerning the Definition of the Concept of "Originating Products" and Methods of Administrative Cooperation, O.J. (1990) L84/8.

16. Keith Steele and Daniel Moulis, "Country of Origin: The Australian Experience," in Bourgeois, Vermulst, and Waer (Eds.), *Rules of Origin in International Trade: A Comparative Study*. Ann Arbor: University of Michigan Press, 1993.

17. Canada-U.S. Free Trade Agreement, Part Two, Ch. Three; See also the following comments by the author of this paper: "Rules of Origin in the U.S.," in Bourgeois, Vermulst, and Waer (Eds.), *Rules of Origion in International Trade: A Comparative Study* (Ann Arbor: University of Michigan Press 1993); "The FTA Rules of Origin and the Rule of Law," Proceedings of the Seventh Judicial Conference of the U.S. Court of Appeals for the Federal Circuit, 128 Federal Rules Decisions 500 (1990); "The FTA Rules of Origin: Boon or Boondoggle?" in Dearden, Hart, & Seger (Eds.), *Living With Free Trade: Canada, The Free Trade Agreement And The GATT* (Institute for Research and Public Policy, Ottawa, 1989); and "The Canada-U.S. FTA Rule of Origin and a Multilateral Agreement," *International Business Lawyer* No. 11, p. 513 (1988).

18. Paul Waer, "EC Rules of Origin," in Bourgeois, Vermulst, and Waer (Eds.) *Rules of Origin in International Trade: A Comparative Study* (Ann Arbor: University of Michigan Press 1993).

European Free Trade Association

The rule of origin used by EFTA (Austria, Finland, Iceland, Liechtenstein, Norway, Sweden, and Switzerland) is based on specified process supplemented by a 50 percent value added test for certain products. In some respects, however, the EFTA rule may be seen as a very liberal CTH system because most of the specified processes are described in four-digit CTH terms. Conversion of materials not falling within a four-digit classification into an article in that classification generally will suffice to confer preferential EFTA origin.[19]

Israel-U.S. Free Trade Agreement

The 1985 Free Trade Agreement between Israel and the U.S. uses the common law substantial transformation test, apparently the only free trade agreement to do so. This probably results from Israel's willingness to "sign on" to the existing U.S. rule when the FTA was negotiated, something Canada declined to do three years later. The Israel-U.S. FTA also contains a 35-percent value-added requirement. For purposes of calculating whether 35 percent of value has been added by the exporting party, the value of products of the other party may be counted for as much as 15 percent of the final value, thereby reducing the value-added requirement to as low as 20 percent.[20] These rules parallel the rules of origin for the Caribbean Basin Initiative.[21]

Mercado Común del Sur (MERCOSUR)

The Treaty of Asunción, establishing MERCOSUR among Argentina, Brazil, Paraguay, and Uruguay, established an origin rule based on CTH, supplemented with a 50 percent value added requirement for processing operations. CTH in MERCOSUR is based on the tariff nomenclature of the Latin American Integration Association.[22]

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19. Convention Establishing the European Free Trade Association (Stockholm, 4 January 1960), Article 4, Annex B, Schedule I.

20. Israel-U.S. Free Trade Agreement, 24 *International Legal Materials* 653, Annex 3:5.

21. Caribbean Basin Economic Recovery Act, Pub. L. No. 98-67, tit. III, subtit. A, 97 Stat. 369, 384-395 (codified as amended at 19 U.S.C.A. §§ 2701-2706).

22. See Argentina-Brazil-Paraguay-Uruguay: Treaty Establishing a Common Market, 31 *International Legal Materials* 1041, Annex II.

North America Free Trade Agreement

NAFTA establishes CTH as the primary rule of origin for preferential trade among Canada, Mexico, and the United States. This is supplemented by value added, particularly in the case of textiles, apparel, and electronic products, by specified process. NAFTA also contains fairly elaborate procedures for verifying claims of origin. Exporters and importers will be required to furnish signed certificates of origin.[23] Records relating to origin must be kept for a minimum of five years.[24] Government officials from each party may conduct origin verifications at the premises of exporters or producers in the territory of other parties.[25] If exporters or producers refuse to permit a verification visit, they may lose preferential tariff treatment for the article that would have been the subject of the visit.[26]

Harmonization of Rules of Origin

The proliferation of different rules of origin has led to a number of attempts to harmonize them, but virtually no progress has been made. In 1976, The Organization for Economic Cooperation and Development (OECD) produced a compendium of rules of origin used by OECD countries. This compendium was followed by the United Nations Conference on Trade and Development (UNCTAD) in preparing a 1982 compendium dealing with rules of origin applicable to developing countries under different preference arrangements. In 1982 the Customs Cooperation Council (CCC) produced a comparative study of rules of origin.[27]

Earlier, in 1973, the CCC approved the Kyoto Convention, which was designed to simplify and harmonize customs procedures including rules of origin. However, the Kyoto Convention merely describes origin systems in use and does not set forth mandatory requirements. In 1981, the GATT Secretariat prepared a note on rules of origin, and in 1982 ministers agreed to study the rules of origin used by GATT's Contracting Parties.[28]

Not much more was heard of rules of origin internationally until well into the Uruguay Round negotiations, but in the late 1980s, developments in three important areas served to focus more attention on the problems posed by rules of origin: (1) increased use of preferential trading arrangements, including regional arrangements, with varying rules of origin; (2) an increased number of origin disputes growing out of quota arrangements, such as the Multifiber Arrangement and the "voluntary" steel export restraints applicable to the U.S.; and (3) increased use of antidumping laws, particularly by the EC and the U.S.,

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23. NAFTA Art. 501 and Art. 502.

24. NAFTA Art. 505.

25. NAFTA Art. 506.

26. Ibid.

27. See U.S. International Trade Commission, *The Impact of Rules of Origin on U.S. Imports and Exports*, USITC Pub. 1695 (May 1985).

28. Ibid.

and subsequent claims of "circumvention" of antidumping restraints through the use of third country facilities.

In September 1989, the U.S. submitted a comprehensive proposal concerning rules of origin to GATT. The U.S. called for a two-step program leading to eventual harmonization of rules of origin. In Step One, the Customs Cooperation Council would provide three reports to the GATT. The first report would identify where change of classification within the Harmonized System of Tariff Nomenclature would result in the transformation of a product sufficient to confer origin, and where change in tariff classification alone may not be adequate. The second report would identify product areas which typically are subject to a variety of rules of origin, or rules different from "the primary rule of origin" used by various countries. The third report would identify non-MFN policies and programs (such as preferences) that are subject to special rules of origin. In Step Two, the Contracting Parties to GATT—using the three studies — would, within a year, negotiate an international agreement harmonizing rules of origin.[29]

The Final Act of the Uruguay Round Agreement signed on December 15, 1993, contains a Rules of Origin Agreement that is basically the U.S. proposal. It would apply to all rules of origin used in nonpreferential commercial policy instruments, thus retaining the distinction between rules of origin and rules of preference.[30] However, as preferential trading arrangements proliferate, rules of preference become correspondingly important. Rules of preference are becoming the rules of origin that really count. Thus, if the GATT agreement on rules of origin harmonizes only nonpreferential rules, its value will be limited.

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29. The text of the U.S. proposal is reproduced and discussed in N.David Palmeter, "The U.S. Rules of Origin Proposal to GATT: Monotheism or Polytheism?", *supra* note 1.

30. General Agreement on Tariffs and Trade, *Final Act Embodying The Results of the Uruguay Round of Multilateral Trade Negotiations*, Section II-11, Article 1.

> 1. For the purposes of Parts I to IV of this agreement, rules of origin shall be defined as those laws, regulations and administrative determinations of general application applied by any member to determine the country of origin of goods provided such rules of origin are not related to contractual or autonomous trade regimes leading to the granting of tariff preferences going beyond the application of Article I:1 of the GATT 1994.
>
> 2. Rules of origin referred to in paragraph 1 shall include, all rules of origin used in nonpreferential commercial policy instruments, such as in the application of: most-favored-nation treatment under Articles I, II, III, XI and XIII of the GATT 1994; antidumping and countervailing duties under Article VI of the GATT 1994; safeguard measures under Article XIX of the GATT 1994; origin marking requirements under Article IX of the GATT 1994; and any discriminatory quantitative restrictions or tariff quotas. They shall also include rules of origin used for government procurement and trade statistics.

Policy Issues

Customs Unions and Free Trade Areas

Article XXIV of GATT permits contracting parties to enter into customs unions and free trade areas covering substantially all of their trade. In a customs union, the members adopt a common external tariff; in a free trade area, each member retains its own external tariff.[31] Rules of origin are more important to free trade areas than to customs unions because of this tariff differential. All other things being equal, processing operations involving materials and components from outside a free trade area would tend to be located in the territory of the member country with the lowest external tariff. Thus, by lowering their external tariffs, free trade area members might "compete" more successfully for investment.

Duty Drawback

Duty drawback is the repayment to an exporter of the duty paid on imported materials included in an exported product. The GATT Subsidies Code provides that the remission or drawback of import charges is not a subsidy if the amount paid is not in excess of the amount levied on imports that are physically incorporated in the exported goods.[32] Because the rules of origin of all free trade areas allow third country materials, suitably altered, to count as a product of the area, the question of drawback must be addressed.

If drawback among members of the free trade area continues, the effect will be to confer the benefits of the free trade area on many third country suppliers. For example, parts from a third country supplier transformed into a preference-eligible product would be dutiable when they enter the first free trade area country. If that duty were refunded to the user of those parts when the finished product is shipped to another free trade area country, the parts effectively would have entered the free trade area free of duty. For this reason, internal duty drawback in a free trade area trade is likely to be discontinued.

Another reason why internal duty drawback is likely to be discontinued in a free trade area is that it would otherwise provide an incentive to locate plants outside the largest market in the free trade area to obtain the benefit of drawback for sales in that market. For example, in NAFTA the largest market is the U.S. If 80 percent of the NAFTA sales of a product occur in the U.S., then sales from a plant located there would benefit from drawback of U.S. customs duty only on the 20 percent of its output which is sold in Canada and Mexico. Conversely, if the plant were located in Canada or Mexico, sales would benefit from drawback on the 80 percent of its output destined for the U.S., as well as on the smaller portion destined for markets in the territory of the other partner.

On the other hand, with internal drawback eliminated, investment would tend to occur in the country with the lowest external duty, all other factors being equal, with the consequent incentive to lower

31. General Agreement on Tariffs and Trade, Art. XXIV:8.

32. Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade, Annex "Illustrative List of Subsidies," paragraph (i). This means that drawback of duties on materials consumed in the manufacturing process, but not physically incorporated in the exported goods (such as polishes), are liable to countervailing duties.

external duty rates. A further effect of internal drawback elimination is to impose the level of protection of the importing country throughout the free trade area. For example, if the duty on a part in Mexico is 10 percent and in the U.S. 5 percent, the part imported into Mexico and incorporated in a finished subassembly there will carry the burden of the 10 percent duty when exported and included in a finished product in the U.S. Because this phenomenon also could influence the location of investment, some members of a free trade area might prefer limited duty drawback, enough to equalize with the level of a lower external tariff in the territory of the importing partner.

Rules of Origin and "DUP" Activities

Brian Hindley has observed that, "Persons who are in favor of an active and 'strong' trade policy are likely to favor rules of origin that foreign producers can satisfy only with difficulty and considerable expense. Protectionist policies will not hit their targets squarely without such rules of origin."[33]

"Strong" rules of origin have been used increasingly in recent years, for trade restricting purposes.[34] Frequently this has been in the context of antidumping investigations. At other times the issue has been quota eligibility, particularly for textiles, apparel, and steel products. As production becomes increasingly global, rules of origin have become an increasingly effective protectionist weapon.

Free trade areas, however, are not intended to be protectionist. Their very purpose is to create trade, not to restrict it. Yet free trade areas can be more trade-diverting than trade-creating, and rules of origin can further trade diversion at the expense of trade creation. It is possible, for example, that producers of tomato catsup in the U.S. and Canada will import more tomato paste from all sources than they do now and thereby increase overall trade. It is also possible, however, that they will merely substitute Mexican tomato paste for Chilean tomato paste and thereby only divert trade.

Whether trade diversion will or will not be the result of catsup-tomato paste rule of NAFTA (or whether it was the intended result), the potential for trade diversion in NAFTA and other regional arrangements is great. The formulation of product-specific rules of origin is, by its nature, very much out of the practical control of generalists and government officials at the policy level, and very much in the practical control of specialists who represent concerned industries. An industry will support a trade pact only if its particular rule of origin is to its satisfactory to that industry. Rarely will there be any effective opposition. The most likely opposition to one country's advocates of a trade restrictive or diverting rule is another country's industry that would benefit from a liberal rule. No doubt at times supporters of a liberal rule have prevailed. But often the solution is likely to be the one reached in the FTA on fresh milk and aged cheese, where the industries effectively said to each other, "You stay on your side of the border, and we will stay on our side."

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33. Brian Hindley, *Foreign Direct Investment: The Effects of Rules of Origin*, Royal Institute of International Affairs, Discussion Paper 30, at 13 (1990).

34. See, generally, N. David Palmeter, "Rules of Origin or Rules of Restriction: A Commentary on a New Form of Protectionism," 11 Fordham International Law Journal 1 (1987).

Rules of this kind result from what Jagdish Bhagwati calls "directly unproductive profit-seeking (DUP) activities." He pronounces DUP appropriately as "dupe."[35] Examples of DUP activities given by Bhagwati include:

(1) tariff-seeking lobbying that is aimed at earning pecuniary income by changing the tariff and therefore factor incomes;
(2) revenue-seeking lobbying that seeks to divert government revenues towards oneself as recipient;
(3) monopoly-seeking lobbying whose objective is to create an artificial monopoly that generates rents; and
(4) tariff evasion or smuggling that de facto reduces the tariff (or quota) and generates returns by exploiting the price differential between the tariff-inclusive legal and the tariff-free illegal imports.[36]

To this list might be added rules of origin lobbying in free trade agreements, the objective of which is to (1) increase one's own exports, at the expense of more competitive suppliers outside the free trade area; (2) block increased competitive imports from within the free trade area; (3) tailor the rule so that one's own specific multicountry operations benefit from the preference while those of one's competitors do not (this may be particularly easy to do with complex, high-technology products); and (4) if all else fails, recall the lesson of the Canadian and U.S. dairy industries, and support a rule that effectively blocks trade.

Of the various methods for formulating origin rules, CTH and specified process are particularly susceptible to this kind of manipulation. Unfortunately, CTH is otherwise the most practical basis for establishing rules of origin for free trade areas. Consequently, governments, whose interest is in liberalizing trade through free trade areas, must guard against the frustration of their policies by those who do not share their interest. The potential for undermining the trade-creating goals of governments with trade-diverting and trade-inhibiting rules of origin is great. "For political reasons," Richard Gardner has observed, "the reduction in trade barriers which takes place in such systems [i.e., preferential trade areas] will probably do more to give the participating countries sheltered markets against the outside world than it does to stimulate vigorous competition between them."[37] Rules of origin are a major weapon in the arsenal of those who would wish to do this.

35 Jagdish Bhagwati, "Directly Unproductive Profit-Seeking (DUP) Activities," *in* J. Eatwell (Ed.) *The New Palgrave Dictionary of Economics* 845-847 (Stockton Press, 1987), *reprinted in* Jagdish Bhagwati (Douglas A. Irwin, Ed.) *Political Economy And International Economics* 129 (Cambridge: MIT Press 1991).

36. Ibid.

37. Richard N. Gardner, *Sterling-Dollar Diplomacy in Current Perspective* 14 (New York: Columbia University Press, 1980 ed.).

Freer Trade Through Complexity

Rules of origin can be used to divert or limit trade in free trade agreements only to the extent that origin is important economically. If MFN tariffs are high, then origin is important; if quotas restrict imports from outside countries, then origin may be even more important.

By the same token, rules of origin bring complexity to the trading system, and complexity serves only to add cost and to inhibit trade. In the preferential EC-EFTA trade, as we have noted, the total economic cost of rules of origin has been estimated at five percent of the value of the traded goods, leading exporters of up to 25 percent of the presumably eligible trade to forego the preference and simply pay the MFN duty.[38]

This suggests that the way to reduce the risk that rules of origin will "do more to give the participating countries sheltered markets against the outside world" than they do "to stimulate vigorous competition between them" is to continue with multilateral efforts to reduce MFN trade barriers even as regional free trade agreements are being pursued. If the multilateral effort is undertaken successfully, at some point more and more exporters in the free trade area will take the option some of the EC and EFTA exporters have taken and will simply ignore the preference as something that costs more than it is worth. The free trade area would become irrelevant, and that, paradoxically, would be the result most in keeping with the trade-creating goals of the designers of free trade areas.

Summary and Conclusion

Rules of origin—or, more accurately, rules of preference—are necessary for free trade areas. They establish which goods are entitled to the preference and which are not. No method of determining origin is completely satisfactory, but for free trade areas, change in tariff heading, or CTH, probably is best. CTH, however, is particularly susceptible to influence by special interests who prefer to divert or restrict trade and, therefore, to defeat the purpose behind the negotiation of free trade agreements — freer trade among the members of the agreement and, therefore, freer trade overall. Rules of origin also add to the cost of trade by adding further administrative complexity to the process. The best way to overcome these problems and to further the goals of a free trade agreement is, paradoxically, to reduce the importance of that agreement and, consequently, the importance of rules of origin by also reducing barriers to trade from sources outside the free trade area.

38. Herin, *supra,* note 7.

HEMISPHERIC FREE TRADE AND THE RESTRICTIONS OF THE MULTI-FIBER ARRANGEMENT

Isidoro A. Hodara

Introduction

One of the goals of the forthcoming Summit of the Americas is to discuss the merits of a hemispheric free trade zone. Whatever its final form, the creation of a free trade zone will be accompanied by the reduction or elimination of tariff and nontariff barriers that restrict trade between member nations. Among nontariff barriers applied by the United States—and to a lesser degree Canada—are restrictions on textile and apparel trade under the Multi-Fiber Arrangement (MFA). These represent quantitative restrictions that currently affect, or have the potential of affecting, exports from at least ten countries within the Western Hemisphere. Textile and apparel exports are significant for a number of Latin American and Caribbean nations, and the elimination of those restrictions merits careful analysis in the context of negotiations regarding market access.

The purpose of this study is to examine these restrictions within the framework of the creation of a hemispheric free trade zone. The study will evaluate the impact of these restrictions on the flow of intrahemispheric trade as well as the multilateral effects of liberalization of the MFA, as a result of the GATT Uruguay Round.

After a brief introduction to the basic issues involved in MFA restrictions, the first section examines the repercussions of MFA restrictions on intrahemispheric trade. The second section analyzes the effects of those restrictions, as well as the effects of their elimination in a hemispheric free trade zone. Hemispheric exporters' participation in total textile and apparel imports is also considered, as well as the fact that corresponding customs tariffs would be eliminated at the same time.

The third section is a review of issues relevant to the objectives of this study. It includes brief analyses of the possible impact of the Uruguay Round with regard to textile and apparel trade, as well as how this subject was dealt with in negotiations of the North American Free Trade Agreement (NAFTA). This analysis provides the framework for reviewing the Multi-Fiber Arrangement's restrictions in the negotiation of a hemispheric free trade zone.

The final section proposes recommendations and conclusions for an adequate treatment (review) of the Multi-Fiber Arrangement's restrictions in the negotiation of a hemispheric free trade zone.

The Multi-Fiber Arrangement and Intrahemispheric Trade

The MFA is a sectoral mechanism for the regulation of the essential components of international trade in textiles and apparel. While conceived under the aegis of GATT, the MFA's provisions contradict the essence of GATT, especially with respect to nondiscrimination and the application of quantitative restrictions.

In accordance with the MFA, quotas (negotiated bilaterally or eventually unilaterally imposed) can be applied for limiting the penetration of textile and apparel imports from certain countries. The only countries to implement these restrictions on imports, however, have been developed nations. As a result, the nations whose flows of trade have been restricted have almost exclusively been developing nations. In the hemispheric context, this has meant that the United States and, to a lesser extent, Canada, have imposed these measures to restrict the exports of textiles and apparels.

This special statute has regulated international trade in textiles and apparel, with few exceptions, for more than 30 years. The original MFA—which emerged from the Long-Term Agreement on International Trade of Textiles and Cotton—has been renewed four times. As Cable (1987) reminds us, it is important to remember that the subject of textiles and apparel has generally been marginalized in successive multilateral negotiation sessions. In fact, both the Kennedy Round and the Tokyo Round included specific measures that required the acceptance of the MFA as a condition for tariff negotiations in the area of textiles and apparel.

Quantitative restrictions designed to help (or inspired by) the MFA[1] generally contain specific limits on physical volume according to product categories for the exporting country in question. These limits represent maximum levels for imports originating from that country, starting with a cessation of trade in the years the agreement is reached. We are not referring to tariff quotas or limitations on a preferential tariff, given that trade within the established quota pays tribute to the full tariff and cannot exceed those limitations, except for those marginal flexibility measures between quotas for different products or during different years. Each quota has a corresponding growth rate, usually under 6 percent, and in the United States for products made of cotton it reaches an annual rate of only 1 percent. In certain cases involving extrahemispheric exporting nations, the United States has even managed to impose reductions on the levels of certain quotas.

Superimposed on this structure of specific limitations on individual products in some cases one or several limitations are added which, for example, establish a maximum volume that can be exported from that place of origin as a totality of textile and apparel products and occasionally for subcategories of those products. Naturally, in order to have restrictive effect, this added limit ends up being less than the aggregate established limits for different individual products that are not subject to the individual quota.

In addition to these effective restrictions, there also exists the possibility of calling an exporting nation in for consultation in order to initiate the process for establishing a quota on products for which one has not been established. The consultations can be the result of the terms of the MFA (especially in the conditions outlined in Article 4) or of the incorporation of a clause into the corresponding bilateral agreement through which the exporting nation accepts resorting to this measure. The United States is notorious for concluding agreements by adopting this second alternative. A more specific measure in this regard, and one that is also used by the U.S., is that of establishing in the corresponding bilateral agreement not a quota but rather a volume amount from which the process of consultation and setting a quota automatically emerges.

1. This calculation is used to include similar measures applied to counties that are not members of the MFA. As we shall see, this also occurs within the context of intrahemispheric trade.

In general, the implementation of the MFA restrictions remains in the hands of the exporting country. The range of restrictions agreed to is incorporated into a Bilateral Textile Agreement that needs to be made known to the Textile Monitoring Agency that was created by the MFA. Once the nature of the MFA restrictions is so described, we are clearly discussing selective safeguarding, one that allows for discrimination between different suppliers and presents a significant obstacle to market access, since a limitation set in this fashion cannot, in principle, be exceeded.

In theory, if quotas are binding only when the level of trade reaches the established limit, practical experience demonstrates that the quota distribution system will, only with difficulty, reach a level of utilization that prevents waste; therefore, this underscores Rafaelli's opinion (1990) that, if a quota is applied at the 80 percent-85 percent level, it is reasonable to assume that trade would have exceeded the quota level in the absence of such a restriction.

More clearly, it is also important to point out the existence of certain special limits applied by the United States. These limits concern the special regime established in the bilateral agreement with Mexico and the special access program created for the nations of the Caribbean Basin Initiative.

Both are inextricably linked to the use of United States tariff item HTS 9.802.00.80 (previously known as TSUS 807). The use of this measure affords apparel and certain manufactured textiles made with cloth manufactured and cut in the United States access to the U.S. market. These items pay only the custom rights corresponding to the value added outside of the U.S.

Both the Special Arrangement with Mexico as well as the Special Access Program for the Caribbean contain special limitations on these types of arrangements calculated more generously than normal specific limitations. In addition, these special limitations (in the case of Caribbean nations, referred to as guaranteed access levels or GALs) are easily increased each time the exporting country requires it, unless the existence of market irregularities can be proven; therefore these special agreements are less restrictive than those normally associated with MFA restrictions.

Restrictions imposed on traditional exporters have created opportunities for new suppliers, who tend to see the imposition of MFA restrictions in a positive light when applied to their competitors. The new suppliers temporarily enjoy the best of both worlds: competitors are limited and their own products are able to penetrate those markets without restrictions. When their exports grow to a level where a quota is imposed they become incorporated into the group of traditional exporters and the opportunity is created for more new suppliers.

The latter would thus have an ambiguous attitude toward liberalization of MFA restrictions. They have the assurance that they will not face restrictions in the future in exchange for their competitors' remaining free from restrictions. A similar process occurs with those nations most recently incorporated into the group of traditional suppliers. They were the last to benefit from quotas imposed on other suppliers and presumably will be the first to lose that advantage if restrictions are removed.

To this, one needs to add that despite MFA terms regarding equal treatment, the quotas represent very different levels of the same product for different suppliers. Those with quotas that significantly surpass their foreseeable trade value obtain unrestricted guaranteed levels of access and will not have the same attitude toward liberalization as those under binding quotas.

Finally, countries that benefit from more liberal systems view with apprehension the erosion of their relative advantage by a more generalized liberalization.

At the beginning of the 1990s, the situation could be described as follows:

- The United States maintained MFA restrictions on textile and apparel trade with Brazil, Colombia, Costa Rica, the Dominican Republic, Guatemala, Jamaica, Peru, and Uruguay, all member nations of the MFA. Similar measures were applied to Haiti, Panama, and Trinidad and Tobago, nations that are not members of the MFA.

- Canada also applied MFA restrictions on certain products originating from Brazil and Uruguay.

United States agreements with nations in the hemisphere, with the exception of those recently signed with Brazil and Mexico, affect a relatively small number of products. Those with Brazil and Mexico have more complete coverage, added limitations, and preagreed consultation provisions.

Members of the Caribbean Basin Initiative (Costa Rica, the Dominican Republic, Guatemala, Jamaica, Haiti, and Trinidad and Tobago) have textile agreements that include a significant number of guaranteed access levels (GALs). In general, these quota assignments—reserved for products manufactured with cloth made and cut in the United States—do not represent a strict reduction on export growth. That is, a quota level applicable to exports of manufactured apparel not made with textiles made and cut in the U.S. coexists with the GAL and has the same characteristics of MFA restrictions as other agreements.

The most recent version of the agreement with Mexico has been significantly liberalized. In 1988, a special system was created which is similar to the creation of the GALs for countries of the CBI. This special system was expanded in 1990 to eliminate quotas for about 50 products and increase remaining quotas by an average of 25 percent. Furthermore, flexibility to accommodate changes in fashion was also added. The agreement with Mexico is one of the least restrictive of those applied by the United States.

The remaining MFA restrictions maintained by the United States with respect to the nations of the hemisphere can be summarized as follows:

- Brazil: about 30 specific limitations on individual or groups of products and an added limit on total textile exports.

- Costa Rica: three specific limitations plus an equal number of GALs for the same products.

- Colombia: only one specific limitation in the agreement's most recent version.

- Dominican Republic: a dozen specific limitations with GAL assignments for seven of those products.

- El Salvador: only one specific limitation.

- Guatemala: one specific limitation accompanied by the respective GAL assignment.
- Haiti: half a dozen specific limitations and four GAL assignments.
- Jamaica: fifteen specific limitations and a dozen GAL assignments.
- Panama: two specific limitations.
- Peru: a dozen specific limitations and two added limitations for two groups of products (all cotton and all wood products, respectively).
- Trinidad and Tobago: ten specific limitations and a similar number of GAL assignments.
- Uruguay: six specific limitations concentrated primarily on wool products, including limits for cardado knits and combed knits.

MFA restrictions applied by Canada on Brazil and Uruguay apply to only a small number of products (in the case of Uruguay there is only one specific limitation).

To place these restrictions in the context of those applied to other suppliers, it is worth noting that the United States has maintained—especially with Eastern suppliers—MFA restrictions that have a much broader coverage, to which a greater number of additional limitations are added for the totality, or portion of product categories.

Typically, the MFA restrictions applied by the United States on traditional Asian suppliers (Japan, Hong Kong, Taiwan, the Republic of Korea, and China) contain not only broader coverage but also measures that provide for smaller quota increases and less flexibility in the use of quotas. In general, those restrictions provide quotas of a higher volume in absolute value, as these countries were among the first suppliers to unleash the application of quotas (historically, Japan was the first, in the mid-1950s, before the creation of international textile agreements).

In conclusion, the narrower coverage allows for the characterization of MFA restrictions applied to Latin American and Caribbean nations as less rigorous than those applied to other suppliers. In fact, for countries that specialize in a relatively small number of products, a limited number of quotas can bring about similar effects as would a greater coverage of quotas for a more diversified supplier nation. On the other hand, the potential impact of measures that allow for consultation and the incorporation of a new product in the quota system when the new product demonstrates a greater penetration into the market should not be underestimated.

Nevertheless, while the four most traditional Asian suppliers represent at least 36 percent of total United States imports of textiles and apparel, the total from Latin American and Caribbean nations is less than half that amount (16.5 percent). At the same time, a little over half of total exports of textiles and apparel from Latin American countries consists of exports originating in nations that are beneficiaries of the CBI, which generally count on diminished restrictions through the assignment of GALs.

Any attempt to determine the relative degree of inherent restrictions on hemispheric exports vis-a-vis those Asian nations should include the analysis carried out by Erzan and Yeats (1992) based on the methodology developed by Erzan (1990). Erzan and Yeats concluded that hemispheric textile and apparel exports face less severe restrictions than those applied to the major Asian suppliers. The benefits of free trade with the United States would be seriously restricted unless the most hard-core barriers are reduced or eliminated, among them are those that affect textiles and apparel.

Effects of Liberalization

In the previous section an evaluation of the range of MFA restrictions affecting intrahemisphere trade led to the following conclusions:

- MFA restrictions applied by the United States, and to a lesser degree Canada, affect the textile and apparel exports of over a dozen Latin American and Caribbean nations.

- MFA restrictions applied by the United States on Mexican exports have undergone recent liberalization and contain a special system. (As will be shown in Section III, the NAFTA Treaty provides for even greater liberalization.)

- Countries of the CBI have a more liberal system than the norm, thanks to the Special Access Program and the assignment of GALs.

- Estimates show that the MFA restrictions on Latin American and Caribbean exports are less rigorous than those imposed on the principal Asian suppliers.

An examination of the impact of a liberalization of MFA restrictions requires a review of the degree of penetration of Latin American and Caribbean textile and apparel exports in the United States market and a review of estimates of the current effects of those restrictions. Second, it is necessary to analyze the results of a liberalization which, in the context of a hemispheric free trade zone, would include both MFA restrictions as well as tariffs.

It is appropriate to consider first the participation of Latin American and Caribbean nations in the United States market. Restrictions imposed by Canada have a much smaller reach and are more focused on specific countries and products.

United States data for the 12 months ending October 31, 1992, (U.S. Department of Commerce 1992b) show that Latin America and the Caribbean shared a level of participation of 16.5 percent of total U.S. textile and clothing imports. Of these, 8.7 percent were from countries belonging to the CBI. Among the principal suppliers are Mexico (ranking seventh), the Dominican Republic (tenth), Brazil (fifteenth) and Costa Rica (nineteenth).

If only apparel is considered, the portion of the total supplied by Latin American and Caribbean countries climbs to 21 percent, and the level for the countries of the CBI reaches 15.6 percent. Among the most important countries of origin for apparel imported by the United States are the Dominican

Republic (fifth), Mexico (eighth), Costa Rica (eleventh), Guatemala (sixteenth), Jamaica (seventeenth), and Honduras (nineteenth).

All of these countries implement special access programs that provide relatively less rigorous MFA restrictions. The one exception is Honduras, on whose exports no MFA restrictions were applied.

With regard to nonapparel textile exports (e.g., knits), the fall of the region's position occurs mostly among members of the CBI (the respective levels of market penetration are 11 percent and 2.09 percent). This is congruent with the concentration of these nations in the exports of apparel using knits made and cut in the United States. In this area, the participation of the principal regional suppliers is more concentrated: Mexico (eighth) and Brazil (tenth) represent three quarters of total exports from Latin American and Caribbean nations.

More specific data, for example in the area of wool apparel, show that the region's share reaches 23.3 percent, but for countries of the CBI it is 16.5 percent The principal regional suppliers are the Dominican Republic (second in the general ranking), Guatemala (sixth), Colombia (ninth), Costa Rica (twelfth), Uruguay (fifteenth), and Mexico (seventeenth). These are averages based on a large number of products and product variations.

The fact that the system of textile management in the United States classifies products under nearly 100 categories, and that these are further differentiated according to market sectors, fashions, seasons, etc., requires more precise analysis at the product and individual variation levels. Countries of the CBI recently exported between 45 percent and 50 percent of total U.S. imports in categories 352 (cotton lingerie), 633 (men's jackets made of synthetic and artificial fibers), and 639 (bras, etc.); and between 30 percent and 45 percent in categories 347 (men's cotton pants), 435 (women's wool jackets), 651 (pajamas made of synthetic and artificial fibers), and 652 (men's underwear).

When penetration reaches significant levels, the conclusion may be reached that production is competitive in quality and price. This is one of the necessary (although not sufficient) conditions for expecting trade expansion as long as liberalization of restrictions is obtained.

To predict which products or categories will most be affected by preferential liberalization of MFA restrictions, the following conditions would have to be monitored constantly in order to consider such factors as, for example, fashion:

- a level of penetration by exports that allows us to infer the existence of a minimum level of competition (the indicators previously discussed were mostly a sum of various different products);

- the main competitors in this area are extrahemispheric suppliers subject to MFA restrictions. If the main competitors belong to the hemisphere, then the possibility of obtaining net advantages for the region as a result of a free trade zone is reduced; and if competitors are extrahemispheric but not subject to quotas (i.e., developed nations) then there is less chance that a hemispheric liberalization will improve conditions of competition significantly;

- the customs rights applicable to third parties be important in order that they reinforce the hemispheric preference derived from the elimination of MFA restrictions; and

- that actual exports to the United States are not disproportionately at the mercy of partial liberalization schemes (e.g., the special system for Mexico or the Special Access Program for countries of the CBI), because the effects of liberalization would be diluted.

Another factor that requires review is estimates of the effects of MFA restrictions that appear in specialized literature. For a compilation of sources of those estimates, refer to GATT (1990). Also see Cable (1987), Erzan (1990), Hamilton (1990), Keesing and Wolf (1980), and Rafaelli (1990).

The most concise qualitative analysis comes from Rafaelli. He has pointed out that the MFA has hurt consumers of importing countries through higher prices, and those of exporting countries by reducing their potential income and employment opportunities and causing a suboptimal assignment of resources in both importing and exporting nations.

Other effects on exporting nations include limitation of competitive exports; disorganization of certain lines of products; transfer of resources to less effective product lines; discouragement of distortion of investment; changes to more sophisticated products and improvement of their quality (as a response to fixed quotas on physical volume); transfer of production to third countries; search for guarantee access through the acceptance of restrictions; problems associated with the management and use of quotas; and political costs of these restrictions.

GATT (1990) compiles estimates of global income lost as a result of exports that did not take place. It cites a study of the United States International Trade Commission (USITC) which indicates that the value of U.S. exports by suppliers subject to MFA restrictions would increase by 20.5 percent for textiles, 36.5 percent for apparel, and globally, by 35 percent. It also cites a study published in the IMF Staff Papers which concludes that textile exports from developing nations to the principal nations of the OECD could grow by up to 82 percent, and exports of apparel by 93 percent.

Another study by the UNCTAD cited in the GATT document states that growth would be 78 percent and 135 percent, respectively, for textiles and apparel, if tariffs and contingencies were to disappear simultaneously. Finally, an estimate based on a general equilibrium model and considering all supplier developing countries suggests increases in global textile and clothing exports of about 244 percent in the United States and 214 percent in Canada. The potential increase of exports must be contrasted with the reduction of income that would result from the loss of contingency income. When dealing with administrative quotas on the part of exporters, it is possible to appropriate income associated with the assistance of the quota under certain circumstances. The same USITC study estimates growth of exports of $5.8-6.0 billion and a loss of income of $1.6 trillion.

One of the conditions for bringing about the creation of contingency income is a binding quota. As was previously mentioned, this would occur with less frequency in Latin America and the Caribbean than in certain Eastern supplier nations because this amount would be less than proportional to the hemispheric participation in total United States textile and apparel imports for the region. In any case, it is worth remembering that this income constitutes a transfer of income and is therefore not comparable to exports, which require real resources for their creation.

Previous estimates are more general than those required in this study. Occasionally they refer to all developed nations, not just the United States and Canada, or all developing supplier nations, and not just Latin America and the Caribbean. In addition, they refer to the *erga omnes* liberalization of MFA restrictions, and not to a preferential dismantling in the context of hemispheric free trade. For this reason they should be considered only as points of reference for more refined calculations.

The study that focuses more specifically on the issues presented in this section is that of Erzan and Yeats (1992). It analyzes the eventual consequences of a liberalization of MFA restrictions maintained by the United States toward Brazil, Colombia, Mexico, Peru, and Uruguay.

Starting from relatively conservative hypotheses, this study concludes that in the short term we should not expect an explosion of exports as a result of the elimination of MFA restrictions imposed by the United States on exports from these five nations, although significant increases would occur, especially for products subject to effective quotas. Nevertheless, the study also adds that even for products that do not face effective quotas, the expansion of exports would be considerable if customs rights were also eliminated, an extreme measure inherent in the process of creating a hemispheric free trade zone.

United States tariffs on textiles and apparel are several times higher than those imposed on other industrial products; they also contain a considerable degree of progressive increases. In this regard, see Yeats (1987), who points out that the effective protection of wool knits in the U.S. is about 85.8 percent. This might be an extreme case, as is verified in the fact that the U.S. customs tariff is a bit of an anomaly since the abnormally high rights of wool knits (about 34 percent) are greater even than that of articles of clothing made with those knits. This point is well illustrated in the study by Mudge Rose Guthrie Alexander and Ferden and IBERC (1990).

Erzan and Yeats conclude by examining the considerable possibilities for expansion of exports. Factors that lead to excessive optimism in this regard are:

- the possibility of a multilateral liberalization, which would erode the value of preferential advantages, and

- the fact that eventual dismantling would be accompanied by some transitory safeguarding measure specifically for textiles and apparel.

Background for Negotiations

This section examines various issues that should be taken into account in negotiating the chapter on textiles and apparel in the general context of a hemispheric free trade zone. It will analyze various possible results of the Uruguay Round and will refer to the treatment of this issue in the negotiation of the North American Free Trade Agreement.

It is crucial to refer to the results of the Uruguay Round with regard to textiles. In fact, the liberalization of MFA restrictions in the heart of a hemispheric free trade zone must take into account the existence of a multilateral liberalization that will be undertaken at about the same time. It seems reasonable to propose that in order for the liberalization of the hemispheric free trade zone to be truly preferential (i.e., that it grant most favorable treatment to member nations), it must be broader, deeper, and quicker than what would be negotiated multilaterally.

In this section, it is assumed that the implementation of the Uruguay Round Agreement will conform to the outline in the corresponding chapter of the Final Act (GATT 1993). The liberalization discussed in that Final Act starts from the premise of the Punta del Este Declaration which established the objective of formulating ways to integrate textile and apparel trade into the GATT, based on strengthened values and disciplines. Added to this was the decision midway through the round that a progressive integration process should start as soon as the round was completed.

The essential components of the planned liberalization program include:

- the commitment not to establish new restrictions beyond those that exist when the agreement from the Uruguay Round is implemented, except as a result of that agreement or GATT rules;
- upon official implementation of the agreement, products which made up 16 percent of textile and apparel trade in 1990 will be integrated. This liberalization, like subsequent ones, should include products from all stages of the production process such as tops and yarns, fabrics, made-up textile products, and clothing (Article 2, paragraph 6);
- approximately by early 1997, the same will occur with products that in 1990 made up 17 percent of trade (Article 2, paragraph 8.a);
- beginning in approximately 2001, an additional 18 percent will be incorporated (Article 2, paragraph 8.b);
- starting in 2004, all of the remaining textile and apparel sector will be integrated into the GATT, thus eliminating all restrictions under the Agreement (Article 2, paragraph 8.c);
- during the first phase of the agreement (36 months) the limit on each MFA restriction will increase annually by 16 percentage points over the growth rate originally predicted (Article 2, paragraph 13);
- during the second stage (from the 37th to the 84th months) limits on remaining restrictions will increase by an additional 25 percent (Article 2, paragraph 14 [i]);
- during the third phase (from the 85th to the 120th months) the additional increase will be 27 percent (Article 2, paragraph 14 [ii]);
- the signatories agree to collaborate to prevent the circumvention of the agreement's measures through complex loopholes or false origin declarations (Article 5);
- a specific safeguard mechanism for the transition period can be applied to any textile or apparel product except those where each importing party has been integrated into

the rules of the GATT. This has to do with a discriminating safeguard, specific to each product, with traits similar to current MFA restrictions however (this would require additional conditions in order to secure adoption, see Article 6); and

- the agreement states that by approximately the beginning of 2004, without possibility of postponement. The textile and apparel sector will be fully integrated into the GATT (Article 9).

It is also relevant to discuss how this subject was dealt with in the negotiations leading to the establishment of the NAFTA because of the precedent it established. This is true even if the Mexican experience does not turn out to be 100 percent transferable to the hemispheric level. In addition, if hemispheric integration does not adopt a "hub-and-spokes"[2] system, then NAFTA measures present an extremely significant precedent. This does not mean (as Weintraub [1995] has argued) that what has already been negotiated will be adopted, and certainly disagreements will emerge with regard to arrangements about the transition period.

At any rate, the NAFTA provisions will prevail over those of the MFA and the Final Act. The liberalization of trade takes into account four basic elements: the elimination of quotas, the reduction of tariffs, the establishment of sectoral rules, and the creation of specific safeguards for textiles and apparel.

Quotas

When the treaty takes effect, it will eliminate the bilateral agreement that established the current MFA restrictions between the United States and Mexico for Mexican products that satisfied the conditions spelled out in the original agreement. For textiles and apparel manufactured in Mexico that do not comply with the original rules set forth in the treaty, quotas in 97 of the 111 current categories will be eliminated. Of those that remain, ten will be eliminated over the course of seven years, and four others over ten years. It will not be possible to impose new quotas unless they are specifically called for in the measures of the treaty that deal with individual safeguards.

Tariffs

Once the treaty takes effect, the highest United States tariffs will be eliminated and tariffs not greater than 20 percent will be imposed on Mexican textiles and apparel. Starting at that level, a progressive tariff dismantling will begin, and its final deadline will be no more than 10 years. At the beginning of that process, the United States will have to eliminate tariffs on Mexican products, which represent about 45 percent of exports to that market.

2. The term "hub-and-spokes" in the original document was coined by R. Wonnacott in Canada to refer to the case of a main associate with free access to imports from various nations, but where each of these nations would have that access only to the products of the principal associate. To examine the results of such a plan, see, inter alia, Krueger (1995) and Weintraub (1995).

Origin

Fairly strict conditions apply. The majority of textiles and articles of clothing are considered to be "of origin" if they are manufactured using cloth made in the region. In the case of knits, it requires that the fiber come from one of the member nations.

The exception will be products made of silk, linen, or other similar materials (those not produced in North America). They will be covered by preferential treatment as long as final processing is carried out in one of the member nations. At the same time, a general review of the rules of origin for textiles and apparel will take place at the beginning of 1998.

For products produced in Mexico that do not comply with requirements regarding origin of textiles and apparel, tariff preference quotas are established for access to the United States and Canada.[3] With this agreement, the limit on Mexican exports of manufactured textiles is equivalent to about 78 million square meters of cloth, and for nonmanufactured textiles, the limit is equivalent to about 31 million square meters. It was also agreed that a process allowing for yearly adjustment to the limitations on the preferential tariff quotas would be put into place.

Safeguards

A system specific to the sector of textiles and apparel was established for the transition period. According to this system, the safeguard mechanism consists of the re-establishment for up to three years of the tariff at the level that existed prior to the treaty's taking effect for goods that comply with origin requirements. Once the period for applying the safeguard is over, then there is a return to the process of tariff reductions ending in the dismantling of customs rights in the time specified in the treaty.

This safeguard, which is applicable to products "of origin," can be used only once for any given product. Further, the country that uses this safeguard mechanism will have to compensate the exporting country by giving it concessions of an equivalent value in the same textile and apparel sector.

With regard to products that do not comply with the agreed origin requirements, the safeguarding mechanism would consist of the imposition of quotas which must respect the trade levels that existed prior to its establishment. These quantitative restrictions can be maintained for up to three years and cannot be applied to trade between the United States and Canada. Thus defined, these safeguards for products that do not comply with origin rules are parallel MFA restrictions that were described in Section I of this study.

The preceding review is intended as an analysis of the major issues to be considered in negotiations on textiles and apparel in the context of a hemispheric free trade zone.

3. The free trade agreement between the U.S. and Canada included similar quotas for both countries, and the quotas for Canada were increased during the NAFTA negotiations.

Hemispheric Free Trade and the MFA: Conclusions and Recommendations

This paper concludes by offering some guidelines for negotiations on the textile and apparel industry (especially with regard to MFA restrictions) within the context of the creation of a hemispheric free trade zone. The point of reference for these guidelines is the liberalization of hemispheric trade, and the first is that the process of multilateral liberalization and regional liberalization of MFA restrictions might occur simultaneously.

It seems obvious that the regional preferential process should be, first and foremost, at least as favorable as the multilateral one. This means that any subsequent advantage resulting from the multilateral preference process should be transferred to the regional preference process, through the use of a principle similar to that of a most favored nation. However, this is not sufficient to ensure that preference will be given to the regional partners. To ensure this, formulas must be devised to guarantee greater speed, coverage, or depth (or all three) to the regional dismantling of MFA restrictions. Specifically, this concept means that if the regional negotiation is completed prior to the multilateral one, the former should contain within it elements that tie progress in liberalization to results from the latter.

A second important point has to do with the need to exercise extreme care with respect to any transitory textile and apparel agreement. It would not make sense for the liberalization process to reintroduce the same type of restriction it seeks to eliminate. In any case, its use should be guided by strict and objective criteria for determining exceptions. Flexible and effective dispute settlement mechanisms would ensure the management of objective criteria and limit discretionary use and the possibility of discrimination. At the same time, it would be appropriate to establish parallel safeguards in a future multilateral liberalization. Each time a specific product is integrated into the GATT, the possibility of involving a more severe safeguard than called for in the multilateral agreement should be eliminated in the regional context.

Third, the negotiation of rules of origin is extremely important. In this regard, cumulative criteria of origin should be provided so that products and goods of each and every member nation of the free trade zone should contribute to the "origin" of a given product. This contradicts hub-and-spokes logic and allows, for example, for Uruguayan cotton to be threaded in Argentina, knit in Brazil, manufactured in Uruguay, and finally enter the United States free of taxes and restrictions as long as these nations are part of the free trade zone.

The opposite scenario requiring bilateral "origin" criteria would produce several problems. Each pair of countries (for example, the United States and one Latin American or Caribbean nation) would incur unnecessary management difficulties, would benefit the manufacturers of intermediate goods of one party for no reason, and reduce the benefits of a more efficient allocation of resources.

In addition, excessively strict rules of origin can become a powerful instrument for protecting those products or processes which emerge as essential in order to confer the character of "origin" on a particular product. Simple principles such as changes in tariff headings are not enough in the textile production chain when they can be achieved without the need to implement substantial modifications on manufactured products (e.g., transforming cloth into sheets). Recognizing their insufficiency (in some cases) should not lead us to the extreme of negotiating restrictive "origin" clauses for all textile products (no fewer than 800 groupings at a 6-digit level on the harmonized system). In any case, the rigor of origin regulations should diminish as the multilateral liberalization process erodes regional preferences.

In the event that both processes result in the elimination of MFA restrictions, the preference would thus be limited to tariff margins. Therefore, it is also reasonable to expect a relaxation of specific origin requirements with respect to textiles and apparel.

A fourth point, closely tied to the previous one, is that of tariff contingencies such as those first established during negotiations between the United States and Canada, and later during NAFTA negotiations. The existence of preferences for products that do not comply with origin conditions is a result of precisely the rigor of origin requirements. With origin rules that are too strict, these contingencies are virtually essential, but they can become superfluous with reasonable origin norms. It is important to remember that the establishment of contingencies is often accompanied by the creation of interests that seek their perpetuation without considering the national interest. Eventually, we could see the dismantling of these contingencies together with the relaxation of rules of origin.

A fifth point is that of equity considerations tied to the existence of different points of departure in the liberalization process. With regard to MFA restrictions on hemispheric trade, this means taking into account the difference between the system currently applied to countries of the CBI and the system that corresponds to other countries in the hemisphere. The relatively advantageous point of departure derived from the more liberal special access program applied to Caribbean nations might end up being an initial disincentive for those countries searching for a greater liberalization of MFA restrictions. If we are talking about a free trade zone, then the starting point for that process would be a dismantling that is applied to all members of that zone and inevitably erodes any advantage at the initial stage. One alternative would be the creation of transitional measures that can maintain a certain degree of preference for some during the transition period. This could be achieved by looking for measures that would result in greater speed, breadth, and depth in the liberalization process for the entire region, rather than through artificially slowing the process in favor of nations that start with a slight advantage in the process.

Finally, we need to consider that a free trade zone involves mutual obligations. For that reason, certain sectors in some nations of the hemisphere should not be surprised if, at the same time that liberalization of MFA restrictions occurs, it also becomes necessary to proceed to a certain degree of liberalization of textile and apparel imports in those nations. Only the United States and Canada would resort to the use of MFA restrictions, but different measures have contributed to the maintenance of local production just ahead of foreign competition in other nations, including that of hemispheric neighbors.

In any case, putting an end to the statute of exceptional protection for the textile and apparel industry in the hemisphere would mean benefits for consumers and producers and would reduce some of the most flagrant distortions. Even when considering a discriminatory liberalization with respect to extra-hemispheric nations, this would constitute a move in the right direction, especially if accompanied by multilateral liberalization of MFA restrictions.

The issues reviewed in this section link specific safeguards, rules of origin, tariff contingencies, existence of different points of departure and generalization of the liberalization do not constitute an exhaustive discussion of the range of issues that should guide the negotiations. This study has highlighted the most significant issues affecting the textile and apparel sectors and the dismantling of MFA restrictions in the context of the establishment of a hemispheric free trade zone. A successful negotiation of a chapter on textiles and apparel will represent an important contribution to the process of trade liberalization in the Western Hemisphere.

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SAFEGUARDS IN THE WESTERN HEMISPHERE FREE TRADE AREA

James H. Cassing

Introduction

Safeguards are temporary government actions to protect an importing country's economy or its industries from import surges and other unforeseen factors. In the typical case, a range of import restrictions is invoked without regard to "fairness" or "dumping" arguments. The sanctions are justified by various legal and political concepts that have been built into national and international trade rules. One such precedent, the "escape clause," descends directly from the United States-Mexican Trade Agreement of another era. Other forms of safeguards range from the legalities of various GATT articles—especially Article XIX—to the "gray areas" of voluntary export restraints and the panoply of orderly marketing agreements such as the Multi-Fiber Arrangement (MFA). More recently, especially in the North American Free Trade Agreement (NAFTA), negotiators discovered unplowed ground such as "safeguards" from the impact of differential environmental standards.

Safeguards presented difficult issues in negotiations for freer trade at both the regional level, as with NAFTA, and the multilateral level, as with the Uruguay Round, and there were deep divisions both between and within developed and developing countries. In part the divisions reflected the vagueness of GATT articles regarding safeguards. More to the point, questions of when and how to tailor exceptions to GATT articles or regional trading bloc rules quickly collide with issues of national sovereignty and raise internal policy debates that cannot easily be disciplined by external rules. It is certainly not clear whether contracting parties to freer trade arrangements will ever agree on exceptions to the rules without the guarantee of "exceptions to the exceptions" and so on.

In a regional trade pact such as a Western Hemisphere Free Trade Agreement (WHFTA), the problems that frustrated safeguards negotiators in the multilateral GATT rounds remain, and new ones arise. This paper will examine safeguards in the context of the countries of the Western Hemisphere and identify where the issue is likely to assist or hinder progress toward a WHFTA. The paper will expose potential conflict in existing policies or positions with respect to safeguards and highlight prospects for resolution. The experiences of the Western Hemisphere nations in forging various regional trading blocs, as well as positions in the Uruguay Round and earlier GATT rounds, will inform the discussion.

Section I briefly reviews current thinking about the political and economic rationale for safeguards. An issue that quickly arises is the extent to which the WHFTA nations even agree on the purpose of safeguards. Section II considers the desirability of keeping safeguards within the multilateral framework and describes the divisions that surrounded safeguards within the Uruguay Round, such as over selectivity, degressivity, surveillance, and the legitimization of "gray area" measures. This section also discusses safeguards in the NAFTA and in the Canada-United States Free Trade Agreement (CUSFTA) documents. Again the various positions of the WHFTA nations are the focus. Finally, Section III briefly considers safeguards more broadly defined—environmental issues, labor conditions, trade adjustment assistance, and so on—and searches for conflict and consensus. This last section also offers a summary and some conclusions.

I. Economic and Political Rationale for Safeguards, and WHFTA Country Positions

Before the Western Hemisphere nations can negotiate a safeguards position, there needs to be agreement on what safeguards are supposed to accomplish. Policy makers and social scientists justify safeguard responses to market disruptions—including for balance of payments reasons—on grounds of both efficiency and equity. (See, for example, Corden 1974, Deardorff 1987, or Mayer 1991; and the references therein.) The efficiency defense, in turn, may include both economic efficiency (owing to adjustment costs) and political efficiency through helping negotiators agree to a politically palatable free trade agreement (Perez-Lopez 1991).

International trade and the movement to freer trade, as through a WHFTA, presents a challenge. On the one hand, the opportunity to trade along lines of international comparative advantage offers a source of growth and prosperity. The relatively more efficient industries of each nation can expand while the relatively less-efficient ones contract. The real national income of every country rises as nations trade for goods they produce comparatively less efficiently. On the other hand, however, there will ordinarily be some adjustment in the industrial composition during the transition to a WHFTA or after the agreement, due simply to changes in the international economy. But this adjustment is not without cost. Some vocal opposition to trade liberalization, and more generally to changing comparative advantage, can be expected—especially if a very large and sudden adjustment were necessary. This raises the possibility that slowing any required adjustment due to the initial agreement, unanticipated import surges, or balance-of-payments difficulties after the agreement is justified on economic or political grounds.

Thinking is changing, and there is no consensus among WHFTA countries on whether the justification for safeguard protection is more political or more economic. This undoubtedly reflects real differences between the economies involved. There is, for example, a history of greater state ownership among some Latin American and Caribbean (LAC) countries, and market signals might be quite distorted internally compared with, say, the United States or Canada. This might well strengthen the economic argument for safeguards in some countries. The same might be said of labor unionization in Argentina and perhaps Brazil.

At the same time, however, the attitudes of Latin American governments toward state ownership are changing. In the steel industry, for example, it was the Latin American governments that first embraced privatization fully, as part of market reform. And various safeguards were explicitly put into place in order to ease the transition (USITC 1992a).

In any case, the WHFTA countries do at least agree that society might prefer to avoid any sudden large trade-related dislocations. (For a discussion of the theoretical issues, see, for example, Corden 1974, Cassing and Hillman 1981, Deardorff 1987, Mayer 1992.) And policy makers may in fact find it impossible to enter into FTA rules without the guarantee of being able to relax those rules under certain conditions (Sykes 1990; see also Cassing 1980, Swan 1989). Safeguards are bound to be an integral part of any WHFTA.

II. Negotiating a WHFTA in a GATT-Compatible Framework: The Treatment of Safeguards

Since World War II many GATT contracting parties have concluded regional trade agreements. The negotiations—certainly those involving the United States, Canada, and Mexico—have usually been in accord with GATT rules. In any case, the discussion proceeds on the assumption that the WHFTA will aim at essential GATT compatibility, as has been the case with both the CUSFTA and the NAFTA.

While one of the pillars of the GATT is the most-favored-nation (MFN) principle of nondiscrimination found in Article I, a major exception to the principle resides in Article XXIV, which governs the creation and operation of regional trade arrangements. If the WHFTA is to be compatible with the GATT, then issues arise as to what forms of safeguards are permissible and the extent to which GATT-acceptable language is in fact acceptable to the WHFTA nations. Of particular concern here are traditional divisions among WHFTA nations over the use, or misuse, of GATT safeguards.

Article XXIV allows both customs unions and free-trade areas. The logic of the drafters was at least in part a recognition that regional trade agreements might serve as stepping stones to freer world trade. At the same time there was concern that nations might use the article to discriminate among trading partners with respect to only a few products, so-called preference arrangements. Therefore Article XXIV clearly requires that restrictions be eliminated on "substantially all the trade" between the countries, that while gradual elimination of barriers is allowed there must be a schedule for completion of reductions "within a reasonable length of time," and that barriers against nonmembers must not be raised beyond preagreement levels.

Despite the concern over preference arrangements, the GATT drafters provided for six exceptions to the requirements of Article XXIV. These are Article XI, which deals with quotas to protect agricultural supports, Articles XII, XIII, XIV, and XV, which deal with restrictions for balance-of-payments purposes, and Article XX, which allows restrictions for purposes of health, safety, and law enforcement. This paper will also consider the role of Article XIX in a WHFTA and focus especially on some of the sharp disagreements this article has engendered; it notes in passing that the GATT also contains Articles XXVIII and XXV, which deal with means for permanently withdrawing a tariff binding and sanctioning voted waivers. While these two forms of safeguards may be important for WHFTA countries, there is currently no controversy surrounding these articles.

Trade Restrictions to Deal With Import Surges

Economists debate the efficiency of safeguards aimed to ameliorate import surges, but such safeguards do provide the political crutch (or insurance) for sovereign states to enter into otherwise binding agreements. Certainly the necessity of such political insurance is almost a consensus position among the WHFTA countries. The issue, then, is whether there is any agreement in interpretation of GATT rules governing safeguards for particular industries.

While the GATT embraces safeguards, the relevant article at the industry level is Article XIX, which has been and still is the focus of much debate. This review follows current legal thinking and recent practice that interpret Article XIX as a sanction of free trade areas. Article XIX provides governments an escape from GATT obligations by allowing trade barriers to safeguard producers seriously injured by trade liberalization. It also contains provisions for foreign compensation for or retaliation against subsequent losses incurred abroad. However, Article XIX does not address nondiscrimination as embodied in Article I. This becomes a sharp issue for any FTA.

Briefly, this "escape clause" is activated as follows:

1. It must be shown that imports of a product are increasing in either absolute or relative terms, and the increase must be caused by unforeseen developments and GATT obligations.

2. It must also be demonstrated that domestic producers of competitive products are seriously injured or threatened with serious injury, and that this injury or threat is caused by the increased imports.

3. If (1) and (2) above are shown, then an importing country is entitled to suspend "such" GATT obligations in respect of such product for such time as necessary to prevent or remedy the injury.

4. The importing country must consult with contracting parties that have a substantial interest as exporters. If no agreement is reached, exporters have the right to suspend "substantially equivalent concessions."

5. Various procedures are defined under GATT or national laws (see especially Jackson 1989).

There is a certain logic to all of this. But in the GATT, what you see is rarely what you get. Article XIX is not always interpreted in a way consistent with the intent of the text. International trade lawyers find the language of Article XIX "extraordinarily oblique" and instead find explanation in the historical development of the language (Sampson 1988, Jackson 1969, 1989).

Some early interpretations greatly weakened the stringency of conditions for resorting to Article XIX. Injury was delinked from trade liberalization, the importing country was ceded much of the power to determine injury to the exclusion of exporters, and it was determined that injury from imports could be serious even with no increase in imports (Sampson 1988, Jackson 1989). What is more, agricultural trade lies largely outside the control of Article XIX. In addition, many invocations of the article have been in cases that "patently fell far short of the requirements of the article" (GATT 1979). Table 1 (p. 237) recounts formal use of Article XIX among the WHFTA countries. Clearly the U.S. and Canada account for most of the formal actions over the years and would join the EC as the leading filers overall.

By the end of the Tokyo Round, there was widespread dissatisfaction with the evolution of Article XIX. A safeguards special group achieved little consensus. Developing countries expected exemptions from safeguard measures of developed countries, and developed countries could not agree on the legitimacy of unilateral action by importers or country selectivity in the application of measures. A committee worked beyond the Tokyo Round to develop a system with "greater uniformity and certainty" (GATT 1980). The Punta del Este Declaration considered a safeguards agreement "of particular importance to strengthening the GATT system" and called for "objective criteria for action" (GATT 1986).

Nonetheless, the language of the CUSFTA and of the NAFTA simultaneously retains the GATT framework for global actions and, notwithstanding the discussion of what is allowed by Article XXIV, makes provision for bilateral emergency actions as well. Thus all of the key divisions regarding safeguards are retained because of the GATT treatment for global actions and amplified by the bilateral (trilateral) actions allowed as well as selective treatment of FTA members even with regard to global actions.

Next is a consideration of the general issues that might divide WHFTA countries along the lines of multilateral treatment generally, treatment of WHFTA nations during and after a transition period, and treatment of nonmembers. The review begins with special reference to the past Uruguay Round negotiations and then to the CUSFTA and the NAFTA accords.

Potential Conflict Over the GATT's Treatment of Safeguards

Among GATT members—including the WHFTA countries—the more obvious divisions involve those developed countries most likely to invoke safeguards and those developing countries and NICs most likely to be adversely affected by such invocation. For both groups, a key concern is balance in moving toward objective criteria for action and adjustment. If the criteria are too lenient, the transparency and certainty sought may come at the cost of easy access to protection. Indeed, if remedies are extended to legitimize the so-called gray-area measures or do not impose credible degressive provisions for adjustment, what remains of the GATT? International trade provides an opportunity for mutual gain through adjustment and change, not through arrest or blockage of required adjustment.

At the other extreme, if the safeguard criteria are too stringent, then industries will simply bypass the rules and seek amelioration through the domestic political process with an appeal to national sovereignty. By one estimate, the share of American imports subject to restraint (especially "voluntary" ones) rose in the 1980s from one eighth to one quarter (*The Economist*, 1990). Worldwide actions are reported in Table 2. As an alternative, and again as is happening now, recourse will be made to "unfair trade" practices and "dumping." It is never enough to view one code or agreement in isolation.

Viewed as a question of balance, the Uruguay Round stumbling blocks provide a guide to at least some of the potential WHFTA divisions. There were essentially three questions.

1. Should discipline be tightened in order to:
   a. restrict the import-restraining tools such as VERs,
   b. enforce degressivity, and
   c. increase surveillance?

Or,

2. Should it entail either or both of:
   a. bringing VERs and other gray-area measures into the GATT, and
   b. legitimizing country selective restraint measures?

And, in any case,

3. Should adjustment assistance be explicit when safeguards are applied?

Simply from the standpoint of the WHFTA countries, not to mention the EC and other GATT members, there is little agreement on the answers to these questions. While the WHFTA countries at least might agree on some version of points (1b) and (1c), the other points are potentially contentious. (For discussion see Wolff, 1983; Hoekman, 1989.)

Selectivity

In the Uruguay Round, the EC tabled a proposal for country-selective application of safeguard measures. This was at odds with the LAC country positions. The United States position on country selectivity is officially still ambiguous. Part of the confusion at least is that it is difficult to oppose country selectivity and yet favor gray-area measures such as VERs.

In search of consensus, WHFTA countries might agree that a potential trap in any freer trade negotiations is to lose sight of what safeguards should theoretically accomplish in the first place. The key is to define "harm" in economic terms so that the national interest will be represented. Good safeguard provisions should work in the direction of adjustment for trade, as discussed in Section II above. Any agreement thus needs to enfranchise and mobilize the proponents of change, including consumers and potential exporters within the importing countries, and it also needs to address the losses of the industries affected.

From this perspective, country selectivity is surely difficult to justify. The Multi-Fiber Arrangement (MFA) proves only too well how such restraints tend to multiply while the most efficient exporters are successively punished. Selectivity tends to weaken the proponents of change (especially among the developing countries) in its "divide and conquer" approach. Nondiscrimination at least shifts the burden of adjustment back where it should be, in the importing country.

Gray-Area Measures

Gray-area measures—VERs, OMAs, etc.—are almost inherently discriminatory and so would be at odds with the positions of any countries that favor nonselective application of safeguards. However, there is some support for recognizing negotiated restraints as a legitimate safeguard. For better or worse, the potential legitimization of gray-area measures has introduced new ideas that might be pursued in a WHFTA. For example, the International Textiles and Clothing Bureau (ITCB) members, the EC, and ASEAN tabled three proposals for phasing out the MFA by recognizing it as a sort of safeguard and then applying the degressivity requirements of the GATT for safeguards. The issue then becomes, what is the price in terms of safeguard allowances which must be paid? Well-defined adjustment would be essential.

Most developing countries—including the LAC countries—mistrust the use of gray-area measures as temporary safeguards. The MFA illustrates their cost to developing countries. While exporting countries receive substantial rents from the controls (Trela and Whalley 1988; Hamilton, de Melo, and Winters 1992; Cassing and Hu 1992), administering the system has itself proved expensive and has the potential to discourage the most efficient producers, who cannot always get licenses. Many such safeguards cause developing countries headaches and cost valuable resources not only in defending themselves abroad from actions but also in the domestic administration of a complex system of restraints imposed by developed countries reluctant to adjust to shifting comparative advantage (Cassing and Parker 1990).

Duration and Degressivity

Safeguards are supposed to be temporary. In the words of the GATT, parties are to apply safeguards only "to the extent and for such time as may be necessary to prevent or remedy such injury." In practice the interpretation here differs across countries. In the United States, safeguards are to be phased out over five years with the possibility of a three-year extension. Canada in the past has also provided for the gradual diminution of safeguard measures. At the same time, however, many countries including the U.S. and Canada have begun to embrace the French concept of "organized free trade" which focuses on "market penetration" and seems to legitimize gray-area measures. These "temporary" safeguards may never be repealed.

More generally, Sampson (1988) has pointed out that duration and degressivity can be tricky. In practice, maximum durations tend to become minimums, and degressivity has led to higher initial protection than might otherwise have been sanctioned.

Surveillance

The surveillance issue rests on what constitutes "harm" and "cause." Currently each nation assesses "harm" to an industry or the overall economy in a way proscribed by the trade laws of each country. For example, in the United States the "escape clause" resides in Section 201 of the Trade Act of 1974, as amended by the Omnibus Trade and Competitiveness Act of 1988. In order to gain temporary relief for an industry it must be shown that imports are a "substantial cause" of injury to a domestic industry. The injury determination is made by the U. S. International Trade Commission (ITC) which, in turn, becomes an obvious pressure point in a 201 case. (See especially Swan 1989 and Maruyama 1989 for a discussion of the evolution and interpretation of Section 201.) What is more, it is ultimately left to national law or politics to determine what has transpired in a declining industry. Need it be said that there have been many controversial interpretations of economic data?

Compensation

One of the reasons frequently cited for the failure of nations to use safeguards and instead resort to more dubious remedies is the compensation clause of Article XIX.3. This has led New Zealand to propose the elimination of compensation in return for more discipline with respect to duration and permissible responses. Whatever the ultimate agreement, there seem to be some consensus among policy makers and scholars that the compensation clause has seriously undercut legitimate applications of safeguards. (See, for example, Tan 1990, Schott 1989, and various papers in Baldwin and Richardson 1991.)

Required Adjustment Assistance

Some have proposed explicit adjustment assistance when safeguards are applied. Nonetheless, nearly everyone agrees that safeguards need to encourage—and not discourage—adjustment, and some have argued that adjustment assistance is an obvious approach. However, so far this is largely viewed as an internal issue. Much the same could surely be said for the WHFTA negotiations as well. (For a discussion of the merits of a more pro-active adjustment policy, see Lawrence and Litan 1986, Richardson 1982.)

Potential Conflict over Treatment of WHFTA Members: Safeguards in the CUSFTA, the NAFTA, and Beyond

The formation of a regional trading bloc raises a number of issues beyond those already addressed in the GATT. Here we will assume that the WHFTA—as with the CUSFTA and the NAFTA—is going to be roughly GATT-consistent but that WHFTA countries may want to continue with their various interpretations of what the GATT allows.

The WHFTA is likely to incorporate some version of Article XIX, notwithstanding the discussion above of its legality in a free trade agreement. The United States, Canada, and Mexico have in the CUSFTA and the NAFTA made clear their position with regard to safeguards in a FTA. This position is divided into bilateral actions—or members in this case—and global actions. There are also transition emergency actions and continuing emergency actions. The transition period to free trade is five to ten years, or sometimes less.

Selectivity

The CUSFTA and the NAFTA treatment of safeguards raises many of the thorny issues confronting the WHFTA. First, the CUSFTA allows for bilateral safeguard remedies during the transition when as a result of the reduction or elimination of a duty there is serious injury to a domestic industry of one member caused by imports of the other. Presumably, such emergency action can be enacted only as a result of net trade creation and not mere trade diversion.

The NAFTA largely retains the CUSFTA wording but rewrites the articles more stringently for cases involving all three countries. For example, during the transition period safeguards can be activated against an imported good to "prevent the injury" as well as merely to "remedy" it. Also, textile and apparel goods are dealt with as special cases.

In the WHFTA, such transitional safeguards are less straightforward. Would the remedies be applied selectively only to the WHFTA members deemed to be the cause of the serious injury? Or would the remedies be applied to all WHFTA members? This is particularly at issue because of trading arrangements already in place—MERCOSUR, CARICOM, ALADI, Andean Pact, and CBI—means that tariffs are not applied uniformly across WHFTA countries and so general reductions are likely to create trade from some members (those facing higher barriers now) and leave trade essentially unchanged from other members (those with preferential access to some members markets already). Nonselectivity would therefore harm some WHFTA members relative to their current positions. Yet during the post-GATT Round the position of most LAC countries was against selectivity on the grounds that selectivity facilitates the divide-and-conquer strategy of some developed-country industries.

In the CUSFTA, the parties retain their Article XIX rights but exclude the other member if global action is taken and imports from the other member are only "in the range of five percent to ten percent or less." In the WHFTA, such wording might preclude effective safeguard action if, for example, 80 percent of imports for a WHFTA member come from 16 WHFTA countries, each with 5 percent of the import market. Also, appeal to global actions may end up falling disproportionately on a few members of the WHFTA.

The NAFTA recognizes this problem and addresses it with some new wording. In particular, a Party is not considered to contribute a "substantial share" to the imports if it is "not among the top five suppliers of the good subject to the proceeding, measured in terms of import share during the most recent three-year period." Also, the wording of the NAFTA allows for the possibility that in exceptional circumstances the imports from two Parties may be considered collectively in determining contribution to serious injury.

The LAIA permits two or more members to negotiate separately on tariff regimes. However, the negotiations are supposed to be designed to be incorporated into the LAIA multilateral system, and even though there are these so-called "partial scope" agreements, the spirit at least is nonselective.

The Andean Group allows for safeguards in a number of ways including "tariff snap-back," a clause that allows a signatory to withdraw concessions under specific circumstances. This is not unlike the provisions of the CUSFTA and the NAFTA and should provide some room for consensus. The issue with regard to selectivity seems to come down on the side of nonselectivity.

The MERCOSUR is largely nonselective with respect to members but has adopted some bilateral working groups to deal with special problems during a transition period. The CACM is in somewhat of the same position following a rocky period in 1970 when Honduras demanded special relief measures owing to the war with El Salvador. Honduras in fact withdrew from the group in December 1970 and often insists on signing bilateral agreements.

Gray-Area Measures

During the Uruguay Round, there was some disagreement in the positions of the WHFTA members regarding VERs. For example, Chile prohibits by law government involvement in voluntary export restraints, although private business is free to conduct business as it will in this regard (GATT, 1991). Yet some of the WHFTA nations have actively and openly embraced market sharing as part of various regional integration attempts. For example, the Argentine-Brazil Economic Integration Pact (ABEIP) of July 1986 explicitly adopted a protocol that called for triggered safeguard measures geared to import surges and bilateral deficits. While this and subsequent regional agreements are an advance over LAFTA—which effectively ended with the LAIA of 1980—there is still a preoccupation with bilateral imbalances even at the industry level. While this probably reflects the earlier belief that economies of scale were the raison d'etre for regional trading blocs, there nonetheless remains some commitment to "orderly markets" and the ABEIP has seen more than its share of orderly marketing arrangements in the name of safeguards—e.g. the steel protocol, the food exemptions, and the automotive industry exemptions (Manzetti, 1990). (More generally, see also Bawa, 1980; Llerena, 1988.)

The U.S. position in the GATT, CUSFTA, and NAFTA generally opposed safeguard application of GATT-illegal gray area measures, not to say that the U.S. always takes its own advice. U.S. trade law in fact is conservative in the sense that it has the same roots as the GATT "escape clause." Remedies largely reside only in duties, and tariff-rate quotas, although orderly marketing agreements also are sanctioned.

In the NAFTA accords, textile and apparel goods are treated differently from other imports for reasons of safeguards and are explicitly exempted from the rules of Chapter 8 of the NAFTA. This, of course, reflects the U.S. and Canada involvement in the Multi-Fiber Arrangement and concerns over Mexico's potential in this area. Nonetheless, it is a sort of legitimization of the gray-area world of voluntary export restraints.

Duration and Degressivity

The CUSFTA and the NAFTA allow for a maximum duration of three years for safeguards applied bilaterally during the transition period. Global actions are governed by current law, again three years duration for the U.S. Degressivity is not explicitly called for in the CUSFTA, although it is in the NAFTA during the allowed one year extension of safeguard relief.

The main issue that arises here is whether or not the WHFTA countries can agree on a maximum allowable duration for safeguards and on a timetable for phasing them out. This issue arises with respect both to the transition period and beyond.

Another important issue that arises in the WHFTA here is related to the selectivity issue above. In the Uruguay Round, as in previous GATT rounds, several WHFTA countries argued for exceptional treatment on the grounds of being less developed countries, as is allowed by the GATT. But this raises the possibility of differential treatment regarding both the duration and degressivity of safeguards. There are two possibilities: Different countries may be allowed exemptions from the safeguards of other countries, or a given country may be allowed a longer duration for safeguards than another country.

Closely related to the degressivity issue is the question of tariff bindings. For example, Colombia reduced tariffs substantially in 1990 and 1991, but the new duties are not bound in the GATT and this raises the possibility that any tariffs raised as "safeguards" could be quite high initially in order to thwart degressivity for a time.

Surveillance

Once again the issue here is what constitutes harm, since WHFTA member countries need to be able to monitor the use of safeguards in various situations. The CUSFTA is explicit only in the sense that it adopts the language of the GATT and current United States and Canadian trade law. Thus the language speaks of "substantial cause of serious injury" and actions justified "to the extent necessary to remedy the injury." The NAFTA replaces this language slightly, but substantively, to include "remedy or prevent the injury." This reflects the U.S. wording in trade law and derives from concern with inventories as a source of potential import surges. Also of concern might be the preoccupation of many LAC countries in previous regional trade agreements with "harm" incurred through balance-of-payments problems not generally attributable to the misfortunes of a particular industry. In the ABEIP, for example, bilateral deficits were used as a measure of harm. Deficits in excess of 10 percent were enough to justify some actions. And Brazil unilaterally applied "stabilization policy tariffs" in 1986-87 while Uruguay delayed joining the ABEIP due to a cumulative trade deficit with both Argentina and Brazil.

Surveillance poses many thorny issues, but it may also provide the format for successful discussion of safeguards. Consider in particular the need to assess "harm" from an economy-wide perspective. A useful institution would be one that mandates a report of the effects of safeguards on all segments of the domestic, WHFTA, and world economies. In particular, any assessment of "harm" must include impact on domestic consumers.

In the NAFTA, the investigating authorities are the Canadian International Trade Tribunal, the Secretaria de Comercio y Fomento Industrial, and the United States International Trade Commission. Given current legal interpretations and past performance, there is probably continued underrepresentation of consumer interests.

Compensation

The issue of compensation relates mainly to global safeguard actions rather than to actions among WHFTA countries as part of any transition to freer trade. Here the NAFTA, like the CUSFTA, adopts the language of the GATT referring to "substantially equivalent" concessions as the price of taking safeguard actions. The questions that confront the WHFTA nations are whether they want to be treated as a bloc when nonmembers owe compensation, and whether the WHFTA nations want to compensate members differently than nonmembers.

During the transition the NAFTA and the CUSFTA do not provide for compensation since emergency actions take the form of moving back to earlier MFN rates. However, the WHFTA nations could debate the possibility of compensation during the transition to freer trade. The questions then arise, what form should compensation take, and should certain WHFTA nations be exempt on development or other grounds? Another approach would be to reduce compensation owing to safeguards and instead extract compensation from countries that resort to safeguards in a way that violates stricter conditions for their use. Brazil at least was vocal in the Uruguay Round on the issue of compensation and has hinted at a resurrection of some variation of the Brazil-Uruguay formula of the 1960s, which would penalize violators of the safeguards code by requiring financial compensation (Abreu and Fritsch 1989).

Required Adjustment Assistance

Among the WHFTA countries, the U.S. has the most extensive adjustment assistance programs, while most WHFTA nations have some version—sometimes ad hoc—of unemployment insurance. Notwithstanding the arguments for and against mandated adjustment assistance in the WHFTA, the issue is probably a nonstarter in initial negotiations, given the complications of harmonizing the conditions under which adjustment assistance is required. No WHFTA nation made this issue a priority in the Uruguay Round, and it did not appear in the final CUSFTA or NAFTA documents.

Nonmembers

The main issue with respect to nonmembers is how they might react to any WHFTA safeguards policy or (for that matter) to the very notion of a WHFTA. If the WHFTA stays essentially within a GATT-compatible framework, then there is at least a reduced potential for conflict. Nonetheless, while it is not the focus of this paper, the whole notion of trading blocs may create an adversarial mindset that would complicate future moves toward worldwide trade liberalization. Certainly the NAFTA has engendered some consternation and concern in East and Southeast Asia.

Other GATT Safeguards

Among the safeguards sanctioned by the GATT beyond Article XIX, there are special provisions for agriculture and for balance-of-payments requirements. Brazil, for example, has justified nontariff import measures on balance-of-payments grounds as in Article XVIIIb. Many WHFTA countries, including the United States and Canada, variously appeal to the exceptions for agriculture in the GATT to justify "safeguards" for the agricultural sector and beyond.

There is potential room for sharp disagreement on some of these safeguards. The essential problem is that the GATT itself has features that inherently divide developed and developing countries. This led to divisions in the multilateral rounds and will surely lead to divisions in the WHFTA negotiation. The origin of these divisions resides in the earlier GATT rounds. Developing countries had little incentive to participate since they were exempt from reciprocity. Major exportable agricultural products were excluded from the negotiations, "special and differential" treatment was accorded through the GSP, and GATT sanctioned infant-industry and balance-of-payments protection in Articles XVIIIc and XVIIIb.

The principal issue here is that if the WHFTA is going to be GATT-compatible, then the WHFTA countries except for the United States and Canada are guaranteed many safeguard remedies in the name of development and structural imbalance in the economy. And as recently as Punta del Este, Brazil led a coalition of developing countries formed to maintain dual-track treatment. Thus a sharp conflict could arise if it is felt that some nations can make concessions for freer trade and then simply fall back on Article XVIIIb or XVIIIc to withdraw concessions.

At the same time, many LAC agricultural producers have expressed disappointment with the GATT's treatment of trade in agriculture. In particular, they perceive that the developed countries use GATT exceptions simply to exclude the agricultural exports of the less-developed countries.

The solution seems to be that some of the WHFTA countries will need to bind their tariff schedules more securely and agree to more stringent limitations on the use of balance-of-payments escape clauses in Article XVIIIb. Some commentators have suggested that reducing the scope of actions to be taken under a balance-of-payments escape clause would make bargaining more likely and improve policy making in developing countries (Fritsch 1989). In the same spirit, the United States and Canada may be forced to re-examine their positions on effective exclusion of major agricultural products from the GATT.

Agriculture-related Safeguards

Since its inception in 1947, the GATT has de-emphasized agricultural matters as the United States and the EC have obtained implicit recognition of their respective domestic policies. These include "safeguard" treatment provided to agriculture through various exemptions such as Article XI, which permits import restrictions to enforce standards or domestic agricultural support policies. In the NAFTA, no trilateral agreement on agriculture was possible. Rather, Canada signed a separate bilateral accord with Mexico while the CUSFTA accord governs trade in agriculture between the U.S. and Canada. Thus, for example, Canada retains its "snap-back" provisions for reinstating tariffs in order to correct market distortions in agriculture. Also, Canada retains its protection for the dairy, poultry, and egg sectors (USITC 1992).

For WHFTA nations like Argentina that are efficient food producers, these exceptions are perplexing. Several WHFTA nations would quickly agree with Argentina—for example, Brazil, Colombia, and Uruguay (Cairnes Group members), as well as Mexico (Cirio and Otero 1989). Nonetheless, given the precedent of moving from the CUSFTA to the NAFTA, we can expect that the United States and Canada will be reluctant to embrace significant domestic reforms. Much here will undoubtedly depend on how the agriculture agreement of the Uruguay Round is finally implemented.

Balance-of-payments and Infant-industry Related Safeguards

Several WHFTA countries frequently appeal to safeguard protection on balance-of-payments grounds. Brazil, for example, represents 60 percent of South America's GDP and 36 percent of its foreign trade. In the past Brazil has used import controls to deal with payments problems. Such controls have included, for instance, the Financial Operations Tax (IOF) on import-related exchange rates—in effect a 15-percent surcharge on imports (United Nations 1985). And recently, Argentina applied a series of measures to raise taxes on imports in order to deal with some of the consequences of tying the peso closely to the U.S. dollar as part of Economy Minister Domingo Cavallo's anti-inflation plan (Nash 1992).

More generally, and without denying the potential benefits of freer trade, it simply may not be realistic to negotiate further WHFTA trade liberalization with heavily indebted LAC countries that are not tied to a financial package that provides for the possibility of adverse trade effects in the short and medium terms. Certainly from the "political efficiency" case for safeguards alluded to earlier, some sort of agreement on temporary balance-of-payments-related trade actions is probably indispensable in a WHFTA. (See, for example, the discussion in Abreu and Fritsch 1989.)

Another potentially deep division between WHFTA countries with regard to safeguards lies in the use of trade and other policies to promote industrialization. While official attitudes are changing, there is not a total rush to abandon some "enlightened guidance" by government policy to nurture certain industries, legally justified in the GATT by an infant-industry argument. While not the primary focus of this paper, it will be one of the tasks of the safeguards surveillance code to monitor the use of the infant industry argument—or, for the United States, the use of temporary "industrial policy" actions.

The "New Safeguards" and Concluding Remarks

As increasingly disparate economies pursue free trade areas, tensions are bound to increase. One form such tensions took in the NAFTA negotiations was a call for "safeguards" from lax environmental or labor standards. Similar issues will undoubtedly arise in any WHFTA negotiation. In his contribution to this publication, Pearson points out that such issues are really questions of domestic policy and are probably best left out of the negotiations. Safeguards are not meant to be permanent and certainly are not intended to safeguard an industry from another nation's source of comparative advantage, even if that does reside in low environmental standards. To open up such essentially domestic issues would certainly be problematic for the WHFTA negotiations.

More generally, the safeguards issue in the WHFTA is bound to be sufficiently complex to generate some consensus and much conflict. In the GATT, CUSFTA, and NAFTA negotiations, safeguards have been a source of some divisions with some consensus on surveillance and degressivity but no general agreement on gray-area measures and other issues. If there is any guidance in these negotiations and from the experience of various other LAC trade negotiations, it is surely that the nations should first seek agreement on precisely what safeguards are meant to accomplish. For example, some criteria of adjustment, efficiency, viability, and focus may serve as a start. As important, there is near-universal agreement on at least one thing: Without the flexibility of safeguard exceptions, WHFTA negotiators will be severely constrained in what they can table and ultimately negotiate.

Table 1
Article XIX Actions Notified to GATT, 1950-88 (WHFTA Countries)

INVOKING PARTY	PRODUCT	DATE INTRODUCED
U.S.	Women's fur felt hats and hat bodies	1 Dec 50
U.S.	Hatter's fur	9 Feb 52
U.S.	Dried figs	30 Aug 52
U.S.	Alsike clover seed	1 July 54
U.S.	Bicycles	19 Aug 55
U.S.	Towelling of flax, hemp or ramie	26 July 56
U.S.	Spring clothespins	9 Nov 57
U.S.	Safety pins	29 Nov 57
Canada	Frozen peas	12 Feb 58
U.S.	Clinical thermometers	22 May 58
U.S.	Lead and Zinc	1 Oct 58
U.S.	Stainless steel flatware	1 Nov 59
U.S.	Cotton typewriter ribbon cloth	22 Sept 60
U.S.	Sheet glass (principally window glass)	17 Jun 62
U.S.	Wilton and velvet carpets	17 Jun 62
Peru	Lead Arsenate and valves	23 Feb 63
Canada	Turkeys	17 Nov 67
Canada	Potatoes	12 Sept 68
Canada	Corn	30 Oct 68
U.S.	Pianos	21 Feb 70
Canada	Motor gasoline	7 May 70
Canada	Men's and boy's woven fabric shirts	2 Jun 70
Canada	Fresh and preserved strawberries	21 May 71
Canada	Men's and boy's shirts woven or knitted	30 Nov 71

U.S.	Ceramic tableware articles	1 May 72
Canada	Fresh cherries	30 Jun 73
U.S.	Ball bearings	1 May 74
Canada	Cattle, beef,veal	12 Aug 74
Canada	Worsted spun acrylic yarns	1 Jan 76
U.S.	Specialty steel	14 Jun 76
Canada	Work gloves	1 Jul 76
Canada	Textured polyester	7 Jul 76
Canada	Double-knit fabrics	8 Oct 76
Canada	Beef and veal	18 Oct 76
Canada	A range of clothing items	29 Nov 76
U.S.	Non-rubber footwear	28 Jun 77
U.S.	Color TV receivers	1 Jul 77
Canada	Footwear	5 Dec 77
U.S.	CB radio receivers	11 Apr 78
U.S.	High carbon ferrochromium	11 Nov 78
U.S.	Industrial fasteners	26 Dec 78
U.S.	Clothespins	23 Feb 79
U.S.	Porcelain-on-steel cooking ware	1 Jan 80
U.S.	Prepared or preserved mushrooms	2 Dec 80
Canada	Non-leather footwear	24 Nov 81
Canada	Leather footwear	9 Jul 82
Canada	Yellow onions	27 Oct 82
U.S.	Motorcycles	16 Apr 83
U.S.	Specialty steel	20 Jul 83
Chile	Sugar	26 Jul 84
Chile	Wheat	
Canada	Fresh, chilled and frozen beef, and veal	1 Jan 85
Chile	Edible vegetable oils	28 Sept 85

Table 2
Voluntary Export Restraint Arrangements, 1987

PRODUCT	IMPORTING COUNTRIES	EXPORTING COUNTRIES
STEEL	EUROPEAN COMMUNITY	AUSTRALIA, AUSTRIA, BRAZIL, BULGARIA CZECHOSLOVAKIA, FINLAND, HUNGARY, JAPAN SOUTH KOREA, NORWAY, POLAND, ROMANIA, SOUTH AFRICA, SWEDEN, VENEZUELA
	UNITED STATES	ARGENTINA, AUSTRALIA, AUSTRIA, BRAZIL, BULGARIA, CZECHOSLOVAKIA, EUROPEAN COMMUNITY, EAST GERMANY, FINLAND, HUNGARY, JAPAN, SOUTH KOREA, MEXICO, NORWAY, POLAND, PORTUGAL, ROMANIA, SOUTH AFRICA, SPAIN VENEZUELA, YUGOSLAVIA, TAIWAN
MACHINE TOOLS	EUROPEAN COMMUNITY	JAPAN
	UNITED STATES	WEST GERMANY, JAPAN, SWITZERLAND, TAIWAN
MOTOR VEHICLES	CANADA	JAPAN, SOUTH KOREA
	EUROPEAN COMMUNITY	JAPAN
	NORWAY	SOUTH KOREA
	UNITED STATES	JAPAN
TELEVISIONS	EUROPEAN COMMUNITY	JAPAN, SOUTH KOREA
	UNITED STATES	SOUTH KOREA
VIDEOTAPE AND CASSETTE RECORDS	EUROPEAN COMMUNITY	JAPAN, SOUTH KOREA
	UNITED STATES	SOUTH KOREA
FOOTWEAR	CANADA	SOUTH KOREA, ITALY, SPAIN, TAIWAN
		JAPAN, SOUTH KOREA
	NORWAY	SOUTH KOREA, TAIWAN
	UNITED KINGDOM	
TEXTILES AND APPAREL	AUSTRIA	SINGAPORE
	CANADA	MALDIVES, PAKISTAN, VIETNAM
		MOROCCO, TUNISIA, TURKEY
	EUROPEAN COMMUNITY	CHINA, PAKISTAN
		CHINA, SOUTH KOREA,
	FINLAND	PAKISTAN
	JAPAN	CHINA
		CHINA, COSTA RICA, EGYPT, ISRAEL,
	NORWAY	MALDIVES, MAURITIUS, PAKISTAN,
	UNITED STATES	SOUTH AFRICA
AGRICULTURAL PRODUCTS	EUROPEAN COMMUNITY	ARGENTINA, AUSTRALIA, AUSTRIA, BRAZIL, BULGARIA, CANADA,CHILE, CHINA, CZECHOSLOVAKIA, HUNGARY , ICELAND, INDONESIA, NEW ZEALAND, POLAND, ROMANIA, SOUTH AFRICA, THAILAND, URUGUAY, YUGOSLAVIA
STAINLESS STEEL FLATWARE	WEST GERMANY	SOUTH KOREA
	UNITED KINGDOM	SOUTH KOREA
LEATHER CLOTHING	NORWAY	SOUTH KOREA
LUMBER	UNITED STATES	CANADA

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DISPUTE SETTLEMENT IN A WESTERN HEMISPHERE FREE TRADE AGREEMENT

Blair Hankey

The purpose of this paper is to examine the potential role and form of dispute settlement in a Western Hemisphere Free Trade Agreement (WHFTA). The paper will outline generic forms of international dispute settlement and examine the structure and functioning of dispute settlement mechanisms in existing subregional trade agreements in the hemisphere. It will then explore issues pertinent to dispute settlement in a WHFTA. Finally, the paper will consider whether some interim dispute settlement arrangement might be applied prior to the formation of a hemispheric FTA.

Introduction

The dispute settlement mechanisms in existing Western Hemisphere trade agreements range from the permanent Tribunal of the Andean Common Market, which is empowered to issue binding decisions with direct application, to the minimalist arbitration procedures of the Caribbean Community, which can issue only nonbinding advisory opinions. The trade agreements are a part of these mechanisms which include several customs unions intended to evolve into common markets, as well as various bilateral free trade agreements.

The architecture of international agreements should be appropriate to their function. Applying this principle to dispute settlement procedures, it follows that the nature of such procedures should be appropriate to the rules they interpret and apply. The more comprehensive, detailed, and intrusive (into subject matter generally considered domestic) are the rules, the more formal, automatic, and binding the dispute settlement procedures should be. Since modern trade agreements increasingly demonstrate the characteristics mentioned, it is not surprising that more attention is being devoted to dispute settlement in negotiation and implementation of trade agreements.

In addition to the general movement toward more formal, automatic, and binding dispute settlement mechanisms in international trade agreements, there are particular circumstances in the Western Hemisphere that are likely to elevate the importance of dispute settlement: asymmetry in power, size, and wealth between the United States and the other countries of the hemisphere; significant differences in cultural, political, and legal traditions between the U.S. and Latin America; and the complex, diffuse power structure of the U.S. Taken together, these factors make it highly unlikely the U.S. will participate in a hemispheric trading arrangement involving an elaborate set of supranational institutions such as those of the European Community (EC).

The absence of formal dispute settlement procedures in an international agreement leaves the relative power of the parties essentially unchanged from the situation before the agreement. Whenever there is a great difference in the relative power of the parties, or when an agreement is much more important to some parties than to others, the weaker parties may be concerned that they will suffer the same disadvantages in a dispute arising after the agreement as they did prior to the agreement unless it includes dispute settlement procedures. Such circumstances are obviously present in this hemisphere: the economy of the United States greatly exceeds in size the combined economies of all the other countries. Trade between the U.S. and any other country of the hemisphere will always be relatively much more important to the *other* country than to the U.S.

Trading relationships within North America illustrate this point. The GDP of the United States is approximately ten times the size of Canada's and thirty times the size of Mexico's. Thus, while bilateral trade between the U.S. and both Canada and Mexico is in rough balance, that trade is ten times more important to Canada than it is to the U.S. and thirty times more important to Mexico. Any retaliatory action would therefore have a much greater impact on Canada or Mexico than it would on the U.S. These differences weaken the bargaining power of the smaller parties in the absence of dispute settlement procedures. Such procedures, at least in theory, give the parties equal weight under the law of the agreement, and therefore should neutralize the power differential between them. It is precisely this neutralizing character of dispute settlement procedures that makes them such an attractive—and even crucial—feature for smaller partners in trading agreements. Converse considerations make dispute settlement procedures a sensitive and difficult issue for a great power like the United States.

While the political leadership of the United States, particularly the members of the legislative branch, may be instinctively reluctant to surrender the advantages that flow naturally from wealth and size, other considerations propel the U.S. to accept formal dispute settlement mechanisms in agreements with hemispheric trading partners. One such consideration is the general desire for friendly, mutually beneficial economic and political relations. Dispute settlement mechanisms can facilitate such relationships by avoiding the escalation of trade disputes that could complicate and disrupt bilateral relations. By resolving disputes in a routine and standardized manner, dispute settlement prevents the escalation of rhetoric, the spiral of retaliatory trade actions, or the linkage with other issues that could sour the overall relationship.

Another consideration is the desire for predictability that is common to business interests in all countries, including the United States. While some businesses in the U.S. will no doubt prefer to rely on superior negotiating leverage to protect their interests, many others will share an interest in minimizing the risk that a particular dispute might escalate. While trade disputes typically involve a single industry, retaliatory measures frequently affect industries other than those involved in the dispute since the retaliating state often does not import substantial quantities of the product at issue from the state that is the object of the retaliation. The results and targets of retaliation are inherently unpredictable.[1]

In the period since World War II, the common security interests of the principal trading nations, particularly the United States, have acted as an important restraining influence over the use of economic muscle to force the resolution of trade disputes. With the collapse of the Soviet Union and the rise on the international agenda of economic issues relative to security concerns, the U.S. may feel less constrained in the use of its economic leverage in disputes with trading partners in the hemisphere. However, to the extent that political rivalry with the former Soviet Union may be replaced by economic rivalry with the European Community (EC) and Japan, the U.S. may still find it prudent not to rely too frequently on the use of economic force to resolve trade disputes within the hemisphere. This observation applies particularly to relations with states such as those in the southern cone, whose trade with the EC or other trading partners may be relatively more important than their trade with the U.S.

1. This observation applies to the sections imposed by the U.S. under Section 301. See Johnson and Winner, "Section 301: A New Direction in U.S. Trade Policy?" In *Private Investors Abroad—Problems and Solutions in International Business in 1987 (Southwestern Legal Foundation)*, 1987, at 5-9.

Types of Dispute Settlement

Not all conflicts between governments can be classified as disputes. Most of the trade-related differences that arise between governments are addressed through diplomatic and other intergovernmental contacts and do not escalate into disputes. Many trade agreements including, for example, the Canada-U.S. Free Trade Agreement (CUSFTA) contain various notification and consultation provisions that aim to prevent small differences from developing into serious disputes.[2]

This paper is concerned with differences that have become "defined, controverted and serious in contrast to other more amorphous, less focused, and less serious types of frictions, concerns, grievances, complaints or differences."[3] Such a dispute may be defined as "a specific disagreement concerning a matter of fact, law or policy in which a claim or assertion of one party is met with a refusal, counterclaim or denial by another."[4]

Dispute settlement provisions contained in international agreements include a range of mechanisms or procedures, from notification and consultation to compulsory, binding third-party adjudication. These procedures can be classified as (a) consultative, (b) conciliatory, (c) advisory (i.e., nonbinding) arbitration, and (d) binding arbitration or adjudication.

Notification, Consultation, and Negotiation

International agreements frequently include provisions requiring one party to notify the other(s) of any actions or measures that may affect the operation of the agreement and to enter into consultations about the matter. The consultations may be subject to a time limit that can be extended only by agreement of the parties. The governments can seek to resolve the issue through direct negotiations at this stage; failure to do so often entitles the aggrieved party to proceed to a further stage of dispute resolution, typically involving the introduction of a third party into the process.

Although parties tend to favor this technique because of the almost absolute control they exercise over both the process and the solution, it has the considerable disadvantage of being based inevitably on a compromise that may turn on factors other than the merits of the case. This disadvantage may be magnified if one party is substantially weaker than the other, or if one party perceives that it has the better case on legal or other merits.

2. See M. Jean Anderson and Jonathan T. Fried, "Dispute settlement between governments: the U.S.-Canada Free Trade Agreement in operation", XVII *Canada-U.S. Law Journal* 1991.

3. See Richard B. Bildner, *When Neighbours Quarrel: Canada-U.S. Dispute-Settlement Experience.* Institute for Legal Studies, 1987.

4. Ibid.

Conciliation or Mediation[5]

Some agreements require that when the parties are unable to reach a negotiated settlement within fixed time limits, either party may refer the dispute to third-party mediation or conciliation. Conciliation procedures take various forms and techniques. Agreements that provide for conciliation generally establish a permanent commission that facilitates negotiations and acts as, or appoints, a mediator. Mediation procedures sometimes include the issuing of a neutral statement of facts. Governments under pressure from private interests may find it useful to be able to rely on the views of an impartial third party in justifying a settlement to its own nationals.

Such consultations are frequently confidential. While confidentiality can avoid the political embarrassment that may result from public negotiation or arbitration, it may not compel the attention of the offending party. Moreover, a solution is likely to be based more on compromise than on principle, and hence will not effectively neutralize differences in negotiating power.

Advisory (i.e., Nonbinding) Arbitration

The essential difference between conciliation or mediation and advisory or nonbinding arbitration is that a mediator typically does not issue a report other than perhaps a neutral statement of facts, but an arbitrator typically issues a report that assigns blame to one party and recommends a solution. This difference is crucial. Even though in law an arbitrator's report may be nonbinding, it fundamentally alters the relative positions of the parties in respect to the dispute. Passing judgment on the merits tends to make it more feasible politically for the offending party to mend its ways. Certainly it becomes easier for the aggrieved party to retaliate. The issue is changed from whether a given measure violates the agreement to whether the offending party will honor its international obligations. The offending party is provided with an objective rationale for modifying its behavior without being seen to succumb to pressure from the other party.

The dispute settlement procedures of the General Agreement on Tariffs and Trade (GATT) fall in the nonbinding category, inasmuch as panel reports become binding on the parties only after they are adopted by the Contracting Parties acting through the GATT Council. Since the Council operates by consensus in such matters, any Contracting Party, including a party to the dispute, can prevent adoption of a panel report.

Binding Arbitration or Adjudication[6]

Agreements providing for compulsory and binding dispute settlement procedures represent a very significant surrender of sovereign power, inasmuch as the parties not only assume obligations, but also confer on the third party the power to interpret their obligations and to order remedies to bring the offending party into compliance with these obligations.

5. The terms conciliation and mediation are used interchangeably.

6. The term "arbitration" is generally applied to a third-party dispute settlement procedure wherein the tribunal or panel is constituted in order to address a specific dispute or group of disputes, and then dissolved. Adjudication generally refers to third-party dispute settlement by a permanent court or tribunal.

The provision for compulsory, binding arbitration—the international equivalent of litigation—tends to encourage governments to settle disputes through negotiation, as arbitration carries many of the same disadvantages as domestic litigation. Binding arbitration and particularly adjudication take both the process and the solution out of the hands of the parties and can easily produce a settlement that, however much it conforms to the rules of an agreement, satisfies the practical interests of both parties far less than would a negotiated solution crafted to the particular circumstances of the parties and the issue.

Since mandatory, binding arbitration goes farthest in neutralizing differences in power, it tends to be favored by smaller states that have the most to gain by subjecting their international relations to a strong legal order.[7]

Dispute Settlement Procedures in Existing Western Hemisphere Trade Agreements

Several bilateral and subregional trade agreements establish free trade arrangements, customs unions, or common markets among the countries of the Western Hemisphere. All these agreements contain some variation of the consultative and conciliation procedures identified in the preceding section. These agreements also provide for some form of advisory or binding arbitration procedure. It is this aspect of dispute settlement, i.e., the role of the third-party arbitration in the overall process, that constitutes the focus of this paper.

The analysis of these procedures in trade agreements already in force in the hemisphere is constrained by several factors. First, apart from the Chapter Nineteen dispute settlement provisions of the CUSFTA, and to a much lesser extent the dispute settlement provisions of the Andean Common Market (Ancom), these provisions appear to have been rarely invoked. Consequently, there is little history or jurisprudence to examine.

Second, apart from the dispute settlement mechanisms of the CUSFTA, there is an extreme paucity of published material on the negotiating history or functioning of these mechanisms. No such literature appears to be available in English. The discussion is therefore limited to an examination of the legal texts that establish the role and competence of these tribunals.

Finally, because virtually all of the subregional and bilateral trade agreements are currently either being constituted or renegotiated, the provisions on dispute settlement in the published texts of these agreements are often already outdated or will soon become so.

Examination of these texts discloses a considerable range in the kind of arbitral or adjudicatory procedures. In the following analysis, these mechanisms are ranked in terms of their compulsory and

7. The Court of Justice of the European Communities represents the most comprehensive and highly developed example of compulsory, binding adjudication in international trade agreements. Actions may be brought to the Court by the EC Commission, by member states, by institutions of the Community, or by private parties. Its judgements have direct application, that is, they have binding legal force on the parties to the case without further judicial, legislative, or executive action by other Community or national organs. Its judgements not only settle the particular disputes before it, but also constitute a body of jurisprudence that construes and elaborates contested provisions of the EC Treaties and secondary legislation. The Court also issues, upon request, preliminary and binding rulings on questions concerning Community law referred to it by the domestic courts of member states.

binding character. At one end of the spectrum (that is, having the most compulsory jurisdiction) is the Andean Tribunal or Court of Justice, while at the other end of the spectrum (that is, having the most consensual jurisdiction) is the dispute settlement mechanism of the Caribbean Common Market (CARICOM).

The Andean Court of Justice

The Andean Court of Justice, or Andean Tribunal, is the permanent tribunal of the Andean Common Market (ANCOM).[8] The treaty establishing the Court was signed in 1979 and entered into force in 1983.[9]

The Court is composed of five justices, one from each of the five member states of the ANCOM. The Court's essential role is the interpretation of the law of the ANCOM.[10] The Court has three functions: to nullify decisions of other organs of the Community that are in violation of the Cartagena Agreement, to issue findings of noncompliance and orders suspending or restricting the benefits of member states that are not in compliance with the jurisdictional norms of the Community, and to render advisory opinions on questions of Community law referred to it by the domestic courts of member states.

Nullification of Community Decisions

Parties that can bring actions for nullification include the member states, the Commission, the Junta,[11] and national or juridical persons who have been injured by laws or regulations issued by Community organs.[12] Once the Court has issued an order of nullification, the Community organ in question (i.e., the Commission or Junta) must adopt the measures necessary to implement the Court's decision.[13]

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8. Agreement on Subregional Integration (The Cartagena Agreement), done May 26, 1969, 8 I.L.M. 910 (1969). The original signatories of the Cartagena Agreement were Chile, Columbia, Peru, Ecuador, and Bolivia. Subsequently, Venezuela joined in 1973. Chile withdrew from the Agreement in 1976. Decision 102 of the Commission of the Cartagena Agreement, October 30, 1976.

9. Treaty Creating the Court of Justice of the Cartagena Agreement, May 23, 1979, 18 I.L.M. 1203 (1979) (entered into force May 7, 1983). The permanent seat of the Court is Quito, Ecuador. The Court scheduled its first meeting for December 1983. See "Venezuela aprobo el tratado que crea et Tribunal de Justicia del Acuerdo de Cartegena," *Interacion Latinoamericano*, September 1983, p. 63.

10. This law has four elements: the Treaty of Cartagena, the Andean Court of Justice Treaty, the Decisions of the Commission, and the Resolutions of the Junta. Andean Court of Justice Treaty, Art. 1.

11. The Junta is the governing council comprised of representatives of the governments of the member states.

12. Ibid., Art. 17, 19.

13. Ibid., Art. 22.

Actions Against Member States

A member country must first bring a complaint of noncompliance against another member country to the Junta. If the offending country fails to comply with a decision issued by the Junta, the Junta may refer the case to the Court, which will issue a decision that can include sanctions for noncompliance.[14] Member states can also bring complaints against other member states *directly* to the Court if the Junta fails to act upon the complaint or finds in favor of the accused country.[15] If a member state fails after three months to comply with a decision the Court has rendered against it, the Court may restrict or suspend benefits under the Agreement of the noncomplying party, after considering the views of the Junta.[16]

Advisory Opinions

National courts of the member states can refer issues of Community law to the Court for interpretation.[17] If the national court's decision is not subject to appeal, the proceeding must be stayed until the Andean Court has ruled. Decisions of the Andean Court interpreting community law are binding upon national courts.[18]

The jurisdiction of the Andean Court is closely modeled after that of the European Court of Justice. The ANCOM, like the EC, aims to create a common market, and it is endowed with a similar set of supranational institutions. Unfortunately, the ANCOM has been in a state of crisis throughout most of the 1980s and, until very recently, has made little progress in the formation of a common market. While an assessment of the ANCOM experience lies outside the scope of this paper, it would appear that the failure until now of the ANCOM to achieve its objectives has been largely the result of political and economic factors rather than of institutional weaknesses.

The Andean Court is an institution with a constitution and jurisdiction befitting the ambitious aims of the ANCOM. Unfortunately, the small number of cases that the Andean Court has tried and the very cursory and abstract nature of the published accounts of those cases, do not permit any considered assessment of the jurisprudence of the Court or its functioning within the Andean system.

Other Latin American Trade Agreements

Four trade agreements among Latin American countries have dispute settlement mechanisms that are similar in their essential characteristics. These agreements are the Latin American Free Trade Agreement (LAFTA), now succeeded by the Latin American Integration Association, generally known

14. Ibid., Art. 23.

15. Ibid.

16. Ibid., Art. 25.

17. Ibid., Art. 28, 29.

18. Ibid., Art. 31.

by its Spanish acronym, ALADI; the Central American Common Market; the MERCOSUR; and the Mexico-Chile Free Trade Agreement.

The dispute settlement mechanisms in each of these agreements share three characteristics. First, the dispute settlement procedures include arbitration before an ad hoc panel. The number of arbitrators, the method of their appointment, and the provisions for rules of procedure and expenses vary from one agreement to another. Second, the arbitration jurisdiction is compulsory. In the event that agreement is not achieved through direct negotiation or the good offices of the governing body of the agreement, the aggrieved party has a right to refer the dispute to arbitration. The consent of the other party or of the governing body is *not* required in order to refer the matter to arbitration. Third, the decision of the arbitration panel is binding. The panel's decision does not have to be adopted or ratified by the governing body in order to become binding, and the aggrieved party does not require the authorization of the governing body in order to take compensatory measures.

The nature of the remedy provided to the prevailing party in the arbitration differs in the various agreements. The Agreement of the Central American Common Market does not specify the nature of the remedy, but simply states that "the decision of the arbitration tribunal . . . shall have the effect of *res judicata* for all the contracting parties as it refers to any aspect of the interpretation or application of the clauses of this Treaty."[19] The LAFTA Protocol for the Settlement of Disputes provides that, in the event a party fails to comply with the decision of an arbitration panel, the party affected by such non-compliance may "limit or suspend concessions . . . to the defaulting party."[20] The MERCOSUR Protocol on Dispute Settlement provides that if one party does not comply with an arbitral decision, the other party may apply compensatory measures such as the suspension of concessions.[21] The Chile-Mexico Free Trade Agreement provides for a draconian sanction in the event of noncompliance: the other party may suspend the operation of the agreement.[22]

The dispute settlement procedures of these agreements apply only between states party to the agreements. Apart from the Ancom, none of the other Latin American trade agreements provides for "standing" or the right of access to the dispute settlement panels by parties other than member states; nor can actions be brought against parties other than member states. Moreover, none of these agreements provides for direct application of the tribunals' decisions. The remedy has in every case to be implemented by further legislation or executive action of the government of a state party.

19. See Article XXVI, General Treaty on Central American Economic Integration, in *Basic Documents on International Economic Law*, Stephen Zamora and Ronald A. Branc, 1990, pp. 529-543. The dispute settlement provisions of the Treaty establishing the Central American Common Market are now undergoing renegotiation and revision.

20. See Treaty of Montevideo creating a Latin American Free Trade Area, ibid., pp. 549-568.

21. MERCOSUR: Protocol for the Resolution of Disputes, done at Brazilia, Dec. 16, 1991, unpublished text.

22. Article 33, Acuerdo de Complementacio Economica entre Chile y Mexico, unpublished text.

Canada-U.S. Free Trade Agreement (CUSFTA)

The Canada-U.S. Free Trade Agreement (CUSFTA) provides for two principal kinds of dispute settlement. These are, first, a general dispute settlement mechanism under Chapter Eighteen of the Agreement, and second a dispute settlement mechanism for antidumping and countervailing duty issues under Chapter Nineteen of the Agreement. The Chapter Eighteen mechanism includes nonbinding arbitration procedures similar to those found in many other trade agreements modeled on the procedures of the GATT. The Chapter Nineteen procedure, however, is unique to the FTA and represents an important innovation in international dispute settlement.

Chapter Eighteen provides for advisory arbitration by ad hoc panels for any disputes that arise under the Agreement which cannot be resolved by direct bilateral negotiations or by the Commission.[23] Although arbitration by the panels is compulsory in the sense that it must proceed if requested by either party, it is not binding unless agreed in advance by the parties in relation to a particular dispute.[24] The one exception is disputes on safeguard measures, as reports rendered by panels on safeguard issues are binding, and the prior consent of the parties is not required to confer this binding jurisdiction. In all other cases, the reports of panels are advisory.

The agreement does provide that:

> Upon receipt of the final report of the panel, the Commission shall agree on the resolution of the dispute, which normally shall conform with the recommendation of the panel. Whenever possible, the resolution shall be nonimplementation or removal of a measure not conforming with this Agreement or causing nullification or impairment . . . or, failing a resolution, compensation.[25]

If the Commission has not agreed on a resolution within 30 days after receipt of the panel's report, and a party considers that its "fundamental" rights or benefits under the agreement are impaired by the contested measure, the party is then free to suspend the application of benefits of equivalent effect.[26]

23. The Commission is comprised of the United States Trade Representative and the Canadian Minister of International Trade, or their designees.

24. This option for binding arbitration has not as yet been utilized.

25. Art. 1807.8.

26. Art. 1807.9. The NAFTA text adopts a general dispute settlement regime similar to that in Chapter Eighteen of the FTA, but with some significant adjustments, largely in the method by which rosters of panelists are formed (single, consensus roster instead of separate national roster, see Art. 2009) and panels selected ("reverse selection" by which one country must select from among the other countries' nationals on the roster—see Art. 2011). Also, unlike the FTA, the NAFTA permits third-country and noncountry panel chairmen. Ibid. In addition, under the NAFTA binding dispute settlement is available to determine whether one country's retaliation in response to another country's failure to comply with a panel report is itself "manifestly excusive." See Art. 2019.

The Chapter Nineteen procedure for resolution of disputes on antidumping and countervailing duty measures is the subject of another paper in this series,[27] and will be addressed only briefly here. Under Chapter Nineteen, binational panels replace judicial review by national courts of antidumping and countervailing duty determinations by national administrative agencies. These panels apply the law of the party whose measure is contested. Either party has the right to challenge the final determinations of the other party's administrative agencies before a panel, and the decisions of panels are final and binding.

Since the parties were unable to reach agreement during the negotiations of the FTA on dumping, subsidy, or countervailing duty issues, there is no substantive law of the agreement to apply. Thus, the Chapter Nineteen dispute settlement mechanism essentially represents a procedural solution to a subject on which the parties were unable to reach substantive agreement. Since some disposition of these issues was a political *sine qua non* for Canada to enter into a free trade agreement with the U.S., this procedural solution was a means of allowing the agreement to go forward.

The principal objectives of the Chapter Nineteen procedure are to provide for impartial application of the respective national laws and to obtain a more expeditious final resolution than is provided by the multitiered national systems of judicial review. Because of several commercially significant and highly politicized countervailing duty measures that the U.S. imposed on Canadian imports during and immediately prior to the FTA negotiations, the Canadian public, business community, and federal and provincial governments were extremely sensitive to allegations that countervailing duty and antidumping decisions of U.S. administrative and quasi-judicial agencies were subject to political influence from domestic producers channeled through their Congressional representatives.

The Chapter Nineteen dispute settlement procedure was intended to be only a interim measure (five to seven years) pending substantive agreement on dumping, subsidy, and countervailing duty issues. However, most observers agree that the procedure is working well,[28] and many constituencies in both countries favor making the procedure a permanent function of the FTA (or its successor) in the event agreement is not reached on the underlying issues.

Caribbean Common Market

The dispute settlement procedure of the Common Market of the Caribbean Community (CARICOM) is closely patterned after the pre-1988 GATT dispute settlement procedure, and resembles in its general outline the CUSFTA Chapter Eighteen settlement procedure.

The Council (the governing body comprised of representatives of the member states) must refer any dispute to an ad hoc tribunal at the request of any "concerned" member state. If the Council or Tribunal finds that any objective or benefit under the agreement is being frustrated, the Council "may," by majority vote, make to the member state concerned such "recommendations" as it considers

27. See Gilbert R. Winham and Heather A. Grant in their contribution to this publication.

28. See, for example, Andreas F. Lowenfeld, *Binational Dispute Settlement under Chapters 18 and 19 of the Canada-U.S. Free Trade Agreement: An Interim Appraisal* (December, 1990), Administrative Conference of the U.S.; and Andreas F. Lowenfeld, *Binational Dispute Settlement under Chapters 18 and 19 of the Canada-United States Free Trade Agreement: An Update* (April, 1991), Administrative Conference of the U.S.

appropriate. If the member state does not comply with the Council's recommendation, the Council "may," by majority vote, authorize any member state to suspend such obligations in relation to the offending state as the Council considers appropriate.[29]

This procedure is compulsory in that the Council must refer the issue to a tribunal at the request of any concerned party. However, the arbitration decision is advisory in that the Council, not the tribunal, formulates and "recommends" the remedy and authorizes retaliatory measures.

This procedure represents an improvement over the GATT procedure, inasmuch as (at least in theory) the Council acts by majority vote—not consensus, as in the GATT—and therefore a party to the dispute cannot block the formulation and adoption of a remedy consistent with the tribunal's report. The procedure resembles the CUSFTA procedure in the nonbinding character of the tribunal's decisions. It may be regarded as having a more binding character than the FTA, inasmuch as the Council acts by majority vote, a procedure that is unworkable in a bilateral agreement where both states are necessarily parties to any dispute and where a majority is not an operative concept. The CARICOM procedure is clearly inferior to the FTA and the post-1988 GATT procedure in the absence of fixed time limits for the various stages in the dispute resolution process. In this respect, the Caribbean Treaty displays its vintage (1973). The treaty, including its dispute settlement provisions, is currently being revised.

Issues

Applicable Law and Relation to GATT

One would expect that the law applied under the dispute settlement procedures of an international trade agreement would be the law of the agreement, that is, the rules that constitute its substance. However, this is by no means always so. Although the substantive rules contained in the agreement will almost always form one source of the norms applied in a dispute settlement procedure under the agreement, these rules are not the only source or even necessarily the most important source of the applicable law.

Some bilateral and regional international trade agreements are essentially "GATT-plus" agreements. They add to, and occasionally subtract from, the body of international trade rules comprised by the GATT and its subsidiary agreements. The GATT, for example, forms part of the law of the EC. The CUSFTA affirms the parties' rights and obligations to each other under pre-existing international agreements to which they are both party, including, by implication, the GATT.[30] Moreover, certain articles of the FTA "affirm" or "incorporate" into the agreement specific GATT provisions.[31]

29. Article 11 of Annex to the Treaty Establishing the Caribbean Community in *Basic Documents on International Economic Law*, supra note 20, Vol. II, p. 664.

30. Art. 104.

31. Articles 501 (national treatment) and 1201 (exceptions) "incorporate" specific GATT provisions; Articles 602 (technical standards) and 1302 "affirm" obligations under specific GATT provisions and its subsidiary Codes; Article 1902.2(d)(1) precludes changes to national antidumping or countervailing duty law that are inconsistent with the relevant provisions of the GATT and with the Antidumping and Subsidies Codes.

The CARICOM and the various Latin American agreements reviewed here do not have the explicit GATT-plus structure of the FTA. That may be, in part, because the objectives of these agreements are so much more ambitious than those of the FTA. However, it is possible that general or specific incorporation of GATT obligations into these agreements would strengthen their legal and policy structure.

In the MERCOSUR agreement, the parties "undertake to abide by commitments made prior to the date of signature" of the agreement. While only agreements negotiated under the framework of the Latin American Integration Association (ALADI) are specifically mentioned, this general undertaking presumably also includes the GATT.[32]

The Chile-Mexico FTA provides that arbitration panels will take into consideration the provisions of the agreement, as well as the rules and principles of other international agreements, in reaching their decisions.[33] Thus, the GATT would appear to be incorporated at least as a subsidiary source of legal norms in the dispute settlement process.

The incorporation by one means or another of GATT rules into bilateral and regional trade agreements, and the use of GATT rules in dispute settlement procedures under these agreements, raises a number of interesting issues. The most important of these is the relationship between, on the one hand, the law of the GATT as interpreted by GATT dispute settlement panels and applied by the GATT Council and the Contracting Parties and, on the other hand, the law of the GATT as interpreted by dispute settlement panels under bilateral and regional agreements and applied by their governing bodies and member states.

One can well imagine the kind of problems that will almost certainly arise at some point when GATT obligations are first interpreted and applied in one manner under a bilateral regional agreement such as the CUSFTA and then interpreted and applied in another manner within the GATT itself. For example, in 1987, a GATT panel established at the request of the U.S. issued a report ruling that Canadian prohibitions on the export of unprocessed salmon and herring violated the GATT. Canada subsequently replaced the offending regulations with a landing requirement that had the same practical effect as the export ban.

The U.S. then challenged the Canadian landing requirements before the first Chapter Eighteen dispute settlement panel initiated under the FTA, alleging that the new Canadian landing requirements also violated Canada's GATT obligations that had been incorporated into the FTA. The FTA panel found that Canadian landing requirements as then implemented also violated the GATT, but it recommended a solution, which the parties eventually applied in a somewhat altered form, that modified rather than struck down the Canadian regulations. It is not inconceivable that a third party with an interest in the matter, such as Japan (which imports large quantities of the fish in question), could go to the GATT and obtain a stricter interpretation of GATT obligations than was issued by the FTA panel. In that case, it is unlikely the U.S. would rest content with the FTA panel's more liberal interpretation.

The incorporation of GATT obligations into other agreements also raises issues of choice of forum. CUSFTA provides that disputes arising under both the FTA and the GATT and its subsidiary

32. Art. 8.

33. Art. 33.

agreements may be settled in either forum at the discretion of the complaining party.[34] However, once the dispute settlement provisions of FTA Chapter Eighteen or the GATT have been initiated with respect to any matter, the procedure initiated must be used "to the exclusion of any other." Since the FTA came into force, both parties have taken the other party to dispute settlement under FTA procedures, in respect of certain disputes involving GATT obligations and under GATT procedures in other disputes involving similar GATT obligations. In certain instances, the factors influencing choice of forum may be technical, for example, whether the offending measure was initiated before or after the FTA came into force. In other instances, however, a party appears to have been moved by tactical and political considerations related to the outcome of the proceeding. To the extent that the offending measure is thought to be looked upon with disfavor by other GATT Contracting Parties, a party to the FTA may consider it advantageous to go to that forum.

At least one international trade agreement in the hemisphere, the Andean Common Market (ANCOM), provides that its adjudicatory body, the Andean Court of Justice, has exclusive jurisdiction over disputes arising under the agreement, so forum shopping is not permitted.

The GATT, of course, is not the only international agreement that can be applied in dispute settlement procedures. For example, as already mentioned, the MERCOSUR specifically requires its member states to "abide by commitments" in prior agreements signed in the framework of ALADI.[35] Presumably, therefore, dispute settlement tribunals formed under the MERCOSUR can turn to these agreements as sources of applicable law.

As trade agreements infringe on other policy areas such as the environment, questions will arise whether or not international trade dispute settlement procedures ought to look to sources of law outside trade agreements, for example, agreements concerning the environment.[36]

A final source of legal norms sometimes applied in international dispute settlement procedures is the national laws of the parties to the disputes. In certain instances, such as the Chapter Nineteen procedure under CUSFTA, the agreement explicitly requires the application of domestic law. In other instances, for example where there may be effective lacunae or ambiguity on some issue in the international agreement, dispute settlement panels will look to national laws as presumptive indications of international obligations.

Structure of Dispute Settlement Procedures

Consistent with the principle that form should follow substance, the structure of dispute settlement procedures should, to a considerable degree, reflect the objectives of the agreements and the content of

34. Art. 1806.

35. Art. 8.

36. Several recent GATT panel decisions, such as the U.S.-Mexico dolphin/tuna dispute, have been strongly criticized by environmental groups in the U.S. and elsewhere for ignoring environmental considerations in their decisions.

the rules they interpret. The more pervasive and intrusive the rules, and the more ambitious the objectives of the agreement, the more compulsory and binding the dispute settlement procedures should be.

If the parties aim to create an agreement with broad scope and intrusive obligations, they might want a dispute settlement mechanism that has the stature and continuity necessary to participate actively, through its jurisprudence, in the development of the juridical structure of the agreement. In general, the dispute settlement procedures in existing hemispheric trade arrangements appear to be consistent with the objectives of these agreements, or at least with the current stage of realization of those objectives. The principal exception would appear to be the Caribbean Common Market (CARICOM), which currently has a weak, and reportedly virtually unutilized, dispute settlement procedure relative to its ambitious aims.

One structural issue to be addressed both in existing agreements and any WHFTA is adjudicatory versus arbitral procedures. The principal advantage of a permanent tribunal is that it is better able than are ad hoc arbitration panels to develop a consistent jurisprudence over the longer term. Such a jurisprudence not only increases the clarity of the agreement but it also effectively develops the agreement, certainly in terms of its precision, and in terms of its scope. Thus adjudication can perform a function in international agreements analogous to the role of the judiciary in domestic legal systems. The permanent character of a tribunal can also add weight and prestige to its decisions. The European Court of Justice is the leading example of the dynamic role that a judicial body can play in building an effective supranational economic entity.

However, the principal advantage of a permanent judicial body—its capacity to develop a consistent jurisprudence—can also be a major disadvantage. Since an ad hoc panel is typically dissolved after it has decided a single dispute, it has limited power and therefore limited opportunity to offend the parties or damage the operation of the agreement. A permanent tribunal, however, could potentially develop a line of jurisprudence that could seriously prejudice the interests of one or more of the parties, and render the entire agreement unacceptable to them. The potential for damage as well as constructive development is therefore considerable.

A middle ground between a purely ad hoc panel and a permanent tribunal is a panel selected from a pre-established roster of panelists.[37] The more the roster is selected by consensus, the smaller the roster, and the more automatic the system of panel selection (for example, rotation or drawing of lots rather than negotiation, unilateral selection, or preemptory strikes), the more the procedure will approach adjudication.

One factor to consider in deciding between adjudication or ad hoc arbitration is the number, length and complexity of the cases that will come before the tribunal. Will a permanent tribunal have enough work to keep its members busy? This potential objection is sometimes addressed by allowing the members of the tribunal certain other forms of employment, such as academic appointments, that do not create unacceptable conflicts with their judicial responsibilities.

In the event some kind of WHFTA is formed, it is most unlikely, at least in its early stages, that the scope, content, and level of the obligations it establishes will warrant the creation of a permanent tribunal.

37. This is the system used in most international trade agreements, including the Canada-U.S. Free Trade Agreement (CUSFTA).

Common vs. Civil Law

The countries of Latin America all possess legal and administrative systems based on the Napoleonic Code or civil law traditions. The U.S., Canada, and the countries of the English-speaking Caribbean, on the other hand, have legal and administrative systems based on the Anglo-Saxon or common law tradition. While these traditions have contributed to the development of different legal and administrative cultures, the significance of these differences for the operation of dispute mechanisms in international trade agreements should not be exaggerated.

These differences have never presented insuperable or even substantial obstacles to the operation of international dispute settlement mechanisms, insofar as such mechanisms apply some form of international law, such as the law of the agreement itself, or the law of other international agreements such as the GATT, or both. International law generally may be regarded as a hybrid of the common and civil law traditions, while more closely resembling civil law systems.

The coexistence of common and civil law systems of the member states of the EC does not appear to be a problem in the operation of the European Court of Justice. Moreover, it is notable that civil and common law systems coexist quite successfully in certain national or subnational jurisdictions such as Canada and Louisiana.

Problems are more likely to arise when the law being applied is the national law of one of the parties to the dispute, as sometimes happens in international investment or commercial arbitrations. Such problems could also occur if a procedure analogous to that in Chapter Nineteen of the CUSFTA were to be applied.

A related issue is the significance (if any) of the Calvo Doctrine, to which most Latin American governments have traditionally adhered. This doctrine holds that nationals of foreign states must rely exclusively on the national judicial system of the host state in settling investment and other disputes, and that accordingly a right to international dispute settlement procedures in such cases does not exist and ought not to be granted.[38] The Calvo Doctrine, however, applies to disputes where at least one of the parties is a private (natural or legal) person. It does not apply to intergovernmental disputes. The Latin American states have frequently resorted to binding arbitration procedures in disputes between themselves. Moreover, it is noteworthy that all the trade agreements among Latin American states examined in this paper include binding dispute settlement procedures, whereas the two agreements between or among countries with common law traditions (the CUSFTA and CARICOM) contain general dispute settlement procedures of a nonbinding character.

The Calvo Doctrine could take on a greater significance if settlement procedures for disputes involving private parties were to be included in a trade agreement. U.S. policy is to insist upon the inclusion of dispute settlement procedures for investment disputes involving U.S. nationals in all bilateral

38. The doctrine first stated by the Argentine Jurist, Carlos Calvo, provides *strictu sensu* that a government is not bound to indemnify aliens for losses or injuries sustained by them in consequence of domestic disturbances or civil war, where the state is not at fault, and that therefore foreign states are not justified in intervening, by force or otherwise, to secure the settlement of claims of their nationals on account of such losses or injuries. See ***Black's Law Dictionary***, Sixth Edition, 1990, p. 205. The doctrine has become associated with a general prohibition against international dispute settlement procedures in disputes involving private parties.

investment agreements.[39] It should be noted, however, that the investment provisions of the CUSFTA are specifically excluded from the dispute settlement provisions of that agreement.

An Integrative Role for Dispute Settlement

The question has been raised whether a common hemispheric system of dispute settlement might promote integration among subregional trade associations such as the ANCOM, CARICOM, MERCOSUR, CACM, and NAFTA, and therefore play a catalytic role in the evolution toward a WHFTA.

As the discussion in this paper rests on the premise that dispute settlement procedures must be appropriate to the agreements they interpret and apply, there would seem to be little point in creating a general dispute settlement mechanism in the absence of an agreement with substantive rules governing trade between the parties. It is, of course, possible that the countries of the hemisphere may wish to have a hemispheric dispute settlement procedure applying the law of the GATT among themselves. However, such an arrangement would appear to offer few, if any, advantages and many disadvantages. The primary disadvantage is the absence of any convincing rationale for the interposition of a level of dispute settlement applying GATT law between the GATT itself and the various subregional trade agreements.

While a general international trade dispute settlement mechanism for the hemisphere probably should await the conclusion of a substantive hemispheric trade agreement, it may be worth considering whether some kind of arrangement for international arbitral review of the application of national trade laws could usefully precede the conclusion of a general hemisphere-wide agreement. This arrangement would involve a procedure similar to that employed under Chapter Nineteen of the CUSFTA.

The Chapter Nineteen mechanism applies only to antidumping and countervailing duty measures. A hemispheric arrangement would likewise apply to national antidumping and countervailing duty measures, but could also apply to other measures taken under national laws that affect international trade or investment. These would include safeguards and customs issues, as well as trade-related intellectual property, investment, and services issues.

The primary objective of such a system would be to insure that national laws that affect the interests of other trading partners in the hemisphere would be applied fairly and impartially. A secondary objective would be to insure that non-nationals would obtain expeditious settlement of claims that national administrative measures were applied against them in a manner inconsistent with the applicable national laws. These objectives—access to neutral, binational, or multinational panels that would ensure that national laws covering certain subject matters are applied to non-nationals fairly, objectively, expeditiously, and without domestic political influences—would, of course represent a major change from the way domestic judicial systems currently work. Although the idea is radical, its results could be very beneficial in promoting the kinds of basic changes in their economic and political structures that many Latin American governments and other constituencies appear to be seeking.

The national administrative structures would, at least in principle, be left undisturbed by such an arrangement. Although their work would be subject to review by binational or multinational tribunals,

39. See Jesswald W. Salacuse, "BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact on Developing Countries" in XXIV *The International Lawyer* 1990, 665, pp. 672-673.

it would doubtless have a very significant impact on the way national authorities applied their laws in matters that affected the interests of non-nationals. What would be changed, and substantially so, would be the judicial systems, since national judicial systems would lose their jurisdiction over all cases dealing with certain matters involving non-nationals.

The greatest advantage of such a system is that it would greatly increase confidence among investors, traders, service providers, and other foreign business interests and thereby promote increased participation by foreign interests in Latin American economic development. Concerns about lack of due process and impartial consideration of claims under the existing administrative and judicial systems have had some chilling effect on investment and trade. The system proposed here could help to relieve those doubts.

Another advantage is that it would bring together trade officials, lawyers, judges, and consultants and familiarize them with the legal and administrative structures and modes of operation in other countries. Such a process could lead over the long term toward some harmonization of administrative and judicial cultures of the hemisphere.

Of course, some measure of harmonization of administrative law would have to *precede* the establishment of such a system, as there would need to be some rough equivalence in the powers of judicial review among countries participating in the hemispheric review system. Country A would not be prepared to subject measures adopted under its national administrative procedures to binational or multinational review at the instance of a foreign national from Country B, unless the relationship between Country B's administration and judicial system would make a similar review of measures adopted under Country B's national administrative procedures a meaningful process.

Chapter Nineteen of the North American Free Trade Agreement (NAFTA) provides that the Mexican administrative system for applying antidumping and countervailing duty measures, as well as the system for providing judicial review of such administrative decisions, will undergo a radical change in order to make the Mexican system susceptible to the dispute settlement procedures adapted from Chapter Nineteen on the CUSFTA.[40] It is possible that some Latin American countries will be less interested in making these kinds of sweeping changes in their administrative and judicial systems in order to have access to such a procedure. This may, in particular, be the case for countries such as those of the southern cone, whose economies are less strongly linked with the U.S. than are the economies of Central America and the Caribbean.

Nationals of some Latin American countries may have more confidence in the administrative and judicial procedures of the U.S. and Canada than vice-versa, and therefore may not believe that a system of hemispheric arbitral review would advance their interests. However, it is not impossible that the business communities in Latin America will see in such a system a means of opening and reforming their own administrative and judicial systems.

Obviously, the idea is radical in its implications for change in the hemisphere and will need further study and discussion before it can be determined whether it has any potential appeal for governments.

40. See NAFTA Art. 1904.15 and Annex 1904.15, Schedule of Mexico.

If the idea proves to have merit, it would be prudent to begin by adopting the system for some specific, rather narrow subject matter such as antidumping and countervailing duty measures. As the current mechanism of frontier barriers such as high tariffs, quotas, and licensing systems are abolished or reduced, the countries of Latin America are bound to turn to measures of contingent protection such as antidumping, countervailing duties, safeguard measures, or all three. The imposition of such measures will probably bring them into conflict with other trading parties. The countries of the hemisphere might therefore soon find themselves in a situation where a Chapter Nineteen-type mechanism would have considerable attraction. The process of negotiation of an agreement to put in place a system of hemispheric arbitral review would itself have a very beneficial effect in terms of educating lawyers, officials, and businessmen about other countries' administrative and legal systems.

Before undertaking active consideration of such a system, other countries in the hemisphere will no doubt wish to observe how the Chapter Nineteen mechanism of the NAFTA is applied and functions in and for Mexico.

Latin American nationalist concerns related to the Calvo Doctrine are bound to be aroused by this idea and may well be sufficiently strong to defeat it. It is also possible that the U.S. will not be willing to concede to the other countries of the hemisphere the kind of arrangement it has offered its two closest neighbors.

Conclusion

Dispute settlement mechanisms in existing subregional and bilateral trade agreements in the hemisphere differ markedly in terms of their compulsory and binding character. In general, the level of obligation the parties owe to the dispute settlement procedure appears to reflect the level of the economic integration sought under the various agreements. The failure to date of the various Latin American and Caribbean integration movements to achieve their ambitious goals does not appear to be attributable to the absence of suitable dispute settlement mechanisms.

If and when the countries of the hemisphere decide to enter into a hemispheric free trade agreement, the dispute settlement mechanisms they adopt will no doubt be appropriate to the level of integration they seek. The dispute settlement mechanism will probably be the most important of the supranational institutions operating under such an agreement, because the U.S. is unlikely to agree to surrender sovereignty to either an international secretariat or an intergovernmental legislative body in which it can be outvoted by the other parties to an agreement. It has, however, agreed to various forms of neutral objective dispute settlement by bi- or multinational tribunals, of which the Canada-U.S. Free Trade Agreement (CUSFTA) is the most relevant to this study. A carefully constructed and effective dispute settlement mechanism may be the most promising of the various institutions that could help equalize disparate economic influence in hemispheric relations and promote the development of supranational legal regimes governing trade and other economic relations among the countries of the Western Hemisphere.

WESTERN HEMISPHERE FREE TRADE AND UNITED STATES TRADE LAWS: THE ROLE OF SECTION 301

Steven L. Husted

Introduction

A Western Hemisphere free trade area confronts its negotiators with many challenges, chief among them whether and how to handle existing United States trade laws that could affect trade relations between the U.S. and the other WHFTA countries even after an agreement is reached. One such law is Section 301 of the Trade Act of 1974. It authorizes the U.S. Trade Representative (USTR) to negotiate, under threat of trade retaliation, the reduction of foreign-government-imposed impediments to trade.

The use of this law, dubbed "aggressive unilateralism" by some trade policy experts, has increased in the past decade, prompted by the United States Congress, which supports strengthening various elements of the statute. Guatemala was the target of the first Section 301 case filed in 1975. Through early 1992, nine more cases were initiated against Latin American countries, and several are still in progress. In addition, in the first year of a supplementary 301 provision known as Super 301, the government of Brazil was branded as one of only three priority countries for market access negotiations, and an additional 301 case was initiated by the USTR.

The increased use of Section 301 has been a source of conflict and controversy in the international community. Actions taken under this law are often perceived as an unreasonable intrusion into national trade policies.[1] One of Canada's chief goals during the Canada-U.S. Free Trade Agreement (CUSFTA) talks was to gain special exclusion from certain trade laws, including Section 301.

What Canada achieved was the creation of a dispute settlement mechanism designed to achieve expeditious and fair resolution to disagreements. This mechanism offers several approaches to dispute settlement including consultations, mediation, binding arbitration, and recourse to outside experts and panels. The negotiators of the North America Free Trade Agreement (NAFTA) agreed to a similar format.

The existence of the CUSFTA dispute settlement mechanism, however, in no way supersedes the authority granted to the USTR. There have already been two 301 cases filed against Canada since the trade agreement between the two countries was signed, and one resulted in trade retaliation. A third case was resolved using the new dispute mechanism.

Section 301 has been discussed in other forums. Most recently, the European Community (EC) targeted Section 301 for negotiation in the Uruguay Round.[2] U.S. negotiators warned that Congress would refuse to ratify any agreement that limited the provision.

1. See Moreira (1990) for an example of the Brazilian view of Section 301.

2. See Julie Wolf, "EC seeks removal of U.S. trade law as part of accord," The *Wall Street Journal,* November 5, 1991, pg. A14, column 3.

It is conceivable that, absent an agreement to the contrary within a WHFTA pact, the use of Section 301 against WHFTA countries will increase. First, if the WHFTA negotiations are successful, then trade will rise and U.S. direct foreign investment will almost certainly expand in the WHFTA countries. As this happens, U.S. firms will undoubtedly experience problems that cause them to seek remedies under Section 301. The greater the amount of trade at stake, the more likely is the U.S. government to respond to political pressure to pursue the case. Moreover, if the agreement is successful in expanding Latin American exports to the United States, then U.S. trade negotiators will enjoy increased leverage in any future negotiations over bilateral disputes. With greater leverage comes the likelihood of additional complaints.

Finally, given the likelihood that the current Uruguay Round will fail to produce an agreement on lowering various nontariff barriers, there will be even more pressure by the United States Congress and various exporter groups to seek to lower barriers within the context of regional trade agreements. If unsuccessful in such talks, then the only recourse may be the unilateral use of Section 301. Thus, there are good reasons for the WHFTA countries to consider the impact of the completion of a WHFTA pact on the use of Section 301.

This paper will examine the role of Section 301 in trade relations between the other countries of the WHFTA and the United States, and it will discuss and analyze options available to these other countries with respect to this law. It will also review the history of Section 301 with reference to disputes between the United States and other WHFTA countries, study the Canada-U.S. approach to dispute settlement, and propose some options for WHFTA.

Section 301 as an Instrument of U.S. Trade Policy

Definition of the Statute and Administrative Procedures

Section 301 of the Trade Act of 1974, as amended by the Trade Agreements Act of 1979 and again by the Omnibus Trade and Competitiveness Act of 1988, provides broad authority to the United States Trade Representative (USTR) to negotiate the elimination of any act, policy, or practice of a foreign government that is viewed to be (a) inconsistent with the provisions of, or otherwise denies the United States benefits under, any trade agreement; or (b) an unjustifiable, unreasonable, or discriminatory burden or restriction on U.S. commerce. Should negotiations fail to produce the desired result, then the USTR has authority under this statute to retaliate against those practices by imposing trade sanctions or by ordering the suspension or withdrawal of U.S. trade concessions.

The statute was first incorporated into U.S. trade law in order to provide a mechanism for giving American firms access to the consultation and dispute settlement mechanisms of the General Agreement on Tariffs and Trade (GATT).[3] Since that time the law has been changed to go well beyond trade disputes covered by GATT. For instance, according to the law in its present form, U.S. commerce includes international trade in goods or services as well as foreign direct investments by U.S. citizens that have implications for trade in goods or services.

3. For more on the relationship between Section 301 and the GATT dispute settlement process, see Feketekuty (1990).

The law also details the types of policies, acts, or practices the USTR is directed to see eliminated. "Unjustifiable" practices are those that violate or are inconsistent with U.S. international rights. "Discriminatory" practices are those that deny most-favored-nation treatment to U.S. commerce. The term "unreasonable" refers to acts, policies, or practices that are not necessarily illegal or inconsistent with U.S. international legal rights but are viewed as being unfair. Examples of such practices identified in the 1988 amendment to Section 301 include (a) denial of investment or trade opportunities; (b) denial of adequate protection of intellectual property rights; (c) tolerance of systematic anticompetitive activities by foreign firms; (d) foreign export targeting; and (e) foreign practices deemed to be antilabor, such as (i) laws restricting the rights of labor unions to organize or bargain collectively, (ii) laws allowing child or forced labor, and (iii) failure by governments to provide standards for minimum wages, hours of work, and occupational health and safety.

A 301 case begins in one of two ways. It may start with a petition filed with the USTR requesting action and setting forth allegations in support of the request. The USTR has 45 days to decide whether to initiate an investigation. The alternative is that the USTR may initiate an investigation, either on his or her own or at the direction of the President of the United States.

The statute spells out several deadlines for possible action. At the outset of an investigation, the USTR is required to request consultations with the foreign country regarding the issues of the case. The goal of these consultations is the negotiation of a binding agreement to eliminate the practice or policy that interferes with U.S. commerce, or agreement of the foreign country to provide compensation, preferably to the U.S. sector that was originally harmed by the policy or practice. If the foreign country is a signatory with the United States of a trade agreement such as GATT or the CUSFTA, and consultations do not produce an agreement at the end of the consultation period specified in the agreement, or after 150 days from the start of the consultations, whichever is shorter, then the matter is to be taken to formal dispute settlement procedures provided under the agreement.

Regardless of whether or not formal dispute settlement is involved, the USTR has a clear deadline for announcing determinations regarding the grounds for action and the actions to be taken in the event that consultations fail. In cases involving formal dispute settlement, the deadline is the earlier of the 30 days after the end of dispute settlement proceedings or 18 months after the initiation of the investigation. In most other cases the deadline is 12 months after the case is initiated, except for cases involving an allegation of the denial of intellectual property rights protection, where the deadline is six months after initiation. Any actions taken by the United States against recalcitrant foreign governments usually must be imposed within 30 days of the USTR's announcement, although delays are possible.

Under the most recent provisions of the act, retaliation is required if the USTR determines that U.S. rights under a trade agreement are being denied or that foreign practices are unjustifiable and a burden or restriction on U.S. commerce. Retaliation can take several forms including suspension or withdrawal of trade concessions, imposition of duties, or other trade restrictions.

Exceptions to mandated action include cases where the United States has received an unfavorable determination or ruling under GATT or other trade agreement dispute settlement process, cases where the USTR determines that the foreign country is taking steps to eliminate the problem or provide compensation, and cases where retaliation would adversely affect the economy or national security of the United States.

If the USTR determines that foreign practices are unreasonable or discriminatory, then mandatory action is not required. However, according to the law, the USTR is to take "all appropriate and feasible action" to eliminate the offending policy or practice. Again, the statute provides the USTR with the authority to impose retaliation or to suspend or withdraw trade concessions.

History of Section 301 Cases

Through early 1992, 88 Section 301 cases have been initiated by the USTR.[4] Table 1 provides some details of each of these cases. The first Section 301 case was filed on July 1, 1975, against the Government of Guatemala on behalf of Delta Steamship Lines, Inc., which complained that Guatemala discriminated against foreign shippers when it required that certain cargoes shipped to Guatemala be carried on Guatemalan vessels. Negotiations between the petitioner and the National Shipping Line of Guatemala produced an agreement and the case was terminated in the summer of 1976.

Asian countries have been the most important target of Section 301: 13 cases have been initiated against Japan; eight against Korea; six against Taiwan; four against India; three against Thailand; and two against China. European countries have been the second most important target of Section 301 cases.[5] Twenty-nine cases have been initiated against one or more countries of the EC. In addition, Austria, Norway, Sweden, Switzerland, and the former U.S.S.R. have each been involved in separate Section 301 actions.

Countries of Latin America are the third most frequent target of Section 301 actions, with eleven cases since 1975. In addition to the Guatemalan case described above, Brazil and Argentina have each been involved in five Section 301 cases.[6] Canada is the only other country to have been charged in Section 301 actions: it has been involved in eight cases.[7]

The use of Section 301 rose dramatically during the Reagan administration, due in part to a switch in trade policy in 1985. At that time, the United States had been experiencing record trade deficits for several years and the U.S. Congress demanded increased protection. To counter these demands, President Reagan announced a new policy that called for international macroeconomic policy coordination to facilitate a decrease in the value of the dollar, which at that time was rising in value. The new policy

4. This total includes both standard and self-initiated Section 301 actions as well as self-initiated Super 301 and Special 301 initiatives. In the country totals that follow, one case (Case #10) is included in both the EC and the Japanese totals.

5. Three of the cases filed against Japan (Cases #74-#76) and two of the cases filed against India (Cases #77-#78) were self-initiated by the USTR as part of the Super 301 exercise mandated by legislation included in the Omnibus Trade and Competitiveness Act of 1988.

6. One of the cases initiated against Brazil (Case #73) was part of the Super 301 initiative.

7. One of these cases (Case #58) did not involve bilateral consultations. Rather, the case grew out of a settlement between the United States and Canada over subsidized softwood lumber exports to the United States. In this case, the Section 301 statute enabled the President to impose a tariff on softwood lumber imports from Canada. This tariff was then immediately repealed when Canada instituted a pre-negotiated export tariff on the product. For more on this case, see below. Two cases (Cases #80 and #87) have been initiated since the formation of the CUSTA.

urged American firms to take greater advantage of measures available to them to fight "unfair" trade in American markets by pursuing antidumping or countervailing duty cases, and it promised that the U.S. government would make more vigorous use of Section 301 in order to open foreign markets to U.S. goods.

To demonstrate its commitment to this change in policy, the government initiated several Section 301 cases, including cases against Japan, Korea, and Brazil. By initiating these cases, the government confirmed that it had an interest in achieving a successful resolution to these disputes, thereby raising the stakes in the negotiating process. These were the first cases ever initiated by the USTR. Since 1985, 19 more have been self-initiated, and such cases now account for 25 percent of all Section 301 actions.

Several of the most recent self-initiations have come because the Section 301 statute has been strengthened in recent trade legislation. In 1989, under the Super 301 provisions of the Omnibus Trade and Competitiveness Act of 1988, the USTR announced that it had identified several practices of three countries, Japan, Brazil, and India, that burdened or restricted U.S. commerce.[8] These practices included barriers to foreign investment and foreign insurance sales by India, import licensing practices of Brazil, and the Japanese government's procurement practices that affected U.S. exports of supercomputers and satellites. The passage and subsequent implementation of Super 301 lead to considerable outcry from U.S. trading partners, who viewed these actions as violations of international law.[9] Indeed, none of the three countries identified as "unfair" traders agreed, at first, to even enter into negotiations with the United States.

All three sets of cases have now been resolved, although the role played by Super 301 in achieving these results is questionable. For instance, in May 1990 the USTR, Carla Hills, announced that, due to dramatic changes in Brazilian trade policy instituted by the newly elected government, she was terminating the case against Brazil. Several cases against Japan were terminated in June 1990, following the negotiation of bilateral trade agreements and the completion of the Structural Impediments Initiative talks. Hills also terminated the two Super 301 cases against India in June 1990, announcing that issues involving investment and services were being negotiated in the Uruguay Round.

Another provision of the 1988 trade bill has led to additional self-initiations. This provision, known as Special 301, requires that the USTR identify countries that fail to provide adequate protection of intellectual property rights. On May 1, 1991, Hills initiated Special 301 cases against India and the Peoples' Republic of China.

Cases Involving Latin America

Latin America's experience with Section 301 has for the most part been limited to U.S. trade disputes with Argentina or Brazil. Several of these cases have been quite contentious, and ultimately

8. Korea and Taiwan escaped being also named as priority countries by agreeing at the eleventh hour to reduce certain trade barriers affecting U.S. exports.

9. For a critical appraisal of Section 301 and Super 301, see Bhagwati (1990). For a defense of these policies, see Feketekuty (1990).

produced no resolution and led to U.S. retaliation. This section describes several of the Latin American Section 301 cases in greater detail.

Case #24: Argentine Hides. In October 1981 the (U.S.) National Tanners' Council (NTC) filed a petition with the USTR alleging a breach by Argentina of the 1979 U.S.-Argentina hides agreement. It called for U.S. concessions on imports of corned beef and cheese and reduced U.S. tariffs on Argentine cattle-hide leather. In return, Argentina agreed to convert its export ban on cattle hides into an export tariff (initially at 20%) and to begin a series of reductions in that tariff to eliminate it by October 1981. The NTC argued that Argentina had failed to institute the final two reductions in the tariff. They also charged Argentina with maintaining a minimum export price on hides greater than the transaction price and assessing the export tax on the higher price, thereby raising an additional barrier to the export of Argentine hides.

The effect of these practices, the NTC argued, was to give Argentine tanners an artificially cheap source of raw cattle hides and thus an unfair advantage in U.S. and third-country markets. The USTR initiated an investigation of the case in November 1981 and consulted with the Argentine government on two different occasions. The talks did not produce any agreement, and in October 1982, President Reagan terminated the hides agreement and increased the U.S. tariff on leather imports.

Case #49: Brazil Informatics. In September 1985, as part of the new trade policy initiative of President Reagan, the USTR self-initiated a Section 301 case against the informatics policies of Brazil.[10] The case was begun in reaction to a 1984 Brazilian law that codified and extended policies followed since the 1970s to promote a national informatics industry. The USTR listed four elements of the informatics law as targets for elimination: a market reserve policy that restricts production and sales of certain products to Brazilian firms; administrative burdens including lengthy inspections of imported goods or the denial of their entry into the Brazilian market; prohibition of foreign investment in certain informatics sectors; and failure to provide intellectual property rights protection for foreign computer software. The USTR estimated in its initial documentation of the case that the Brazilian policy had imposed annual lost sales of $340-$450 million on U.S. makers of computer hardware and software.

Following four fruitless bilateral discussions, President Reagan determined that the Brazilian informatics policy was "unreasonable" in October 1986. At that time, he order the USTR to notify GATT of the U.S. intention to suspend tariff concessions for Brazil and to effect such suspension when appropriate. However, he postponed ordering retaliation and continued the case until December 30. In December, the USTR suspended the case with respect to market reserve and administrative burdens on imports, citing improvements in Brazil on these matters. However, President Reagan threatened retaliation within six months should continued negotiations fail to achieve progress on intellectual property protection and on investment issues.

10. Informatics refers to those industries that incorporate digital technology, including computers, computer parts, communications switching equipment, instruments, process controls, optical and electronic components, and computer software.

On June 30, 1987, the USTR suspended that portion of the case dealing with intellectual property rights protection based on Brazilian legislative action toward enactment of a bill that would provide copyrights to computer software. By November, however, misunderstandings re-emerged and the negotiations again collapsed. The President announced his intention to prohibit the import of Brazilian informatics products and to raise duties (to 100%) on $105 million of other Brazilian products. But before retaliation was implemented the Brazilian legislature enacted a new software copyright law. In February 1988, retaliation was indefinitely postponed. Later that year, the USTR announced that it did not wish to pursue retaliation, although it would continue to monitor Brazilian practices toward U.S. firms.

Case #53: Argentina Soybeans and Soybean Products. In April 1986, the (U.S.) National Soybean Processors Association (NSPA) filed a petition against the practices of the Argentine government with respect to its system of export taxes on soybeans and soybean products. The complaint raised by NSPA was over the differential in the export taxes assessed against raw soybeans and processed soybean products; in 1986 the export tax on soybeans was 28.5 percent and 16.5 percent on soybean oil and meal. NSPA argued that the higher tax on raw soybeans discouraged their export and artificially lowered their price inside Argentina. This, NSPA maintained, provided an implicit subsidy to soybean processors and represented a major factor for the declining share of U.S. products in third-country markets. The goal of the NSPA petition was a reduction in the differential. The U.S. soybean growers association also supported the NSPA petition and urged the USTR to take a position in its negotiations that the differential should be removed by raising the lower of the two taxes to the higher level.

Following bilateral consultations, President Reagan suspended the investigation in May 1987, when Argentina assured the United States that it was planning to eliminate its export taxes. In February 1988, Argentina reduced the differential by 3 percent. However, later that year Argentina instituted a tax rebate scheme on soybean product exports, and consultations were resumed. The tax rebate scheme was suspended in December 1988. As of early 1992, the export tax differential was still in place, standing at 6 percent; the USTR continues to consult with Argentina periodically over its policies toward its soybean processing industry.

Case #61: Brazil Pharmaceuticals. In June 1987, the (U.S.) Pharmaceutical Manufacturers Association (PMA) filed a petition complaining of Brazil's lack of process and patent protection for pharmaceuticals. In particular, pharmaceutical products had not been patentable since 1945 and processes were excluded from patent protection in 1969. The PMA claimed in their petition that this lack of protection enables pirate producers to import and/or copy raw materials as well as finished products without the burden of covering the cost of innovation. As an additional hindrance to foreign producers, in some cases Brazil restricted imports of foreign products when domestic pirated products were available in the local market, banned foreign investment that would compete with Brazilian-owned pharmaceutical companies, and placed strict price controls on many drugs. The PMA estimated that the cost of these policies in terms of lost exports over the period 1979-1986 stood at $204 million.

The USTR initiated an investigation in July 1987 and requested bilateral consultations. Talks were not held until the following February, and they achieved no progress on the issue. In July 1988, President Reagan declared Brazil's policy to be unreasonable and a burden on U.S. commerce. In October 1988, retaliatory 100-percent *ad valorem* tariffs were imposed on $39 million worth of Brazilian exports to the United States, including certain paper products, nonbenzenoid drugs, and consumer electronics. In June 1990, the Brazilian government announced that it would seek legislation to provide patent protection for pharmaceutical products and the process of their production. One day later, the USTR announced that it would terminate the application of retaliatory duties on Brazilian goods. In May 1991, the USTR reported that although the Brazilian government had submitted patent legislation to its congress, the proposed law contained certain deficiencies.

These four cases illustrate many interesting points about Section 301 trade policy. First, it is not surprising that major trade disputes have arisen between the United States and Brazil and Argentina. These latter two countries are major markets in Latin America, and until recently they have followed import-substitution development policies that adversely affect U.S. exports. In addition, these countries share comparative advantage with the United States in certain agricultural products. Policy changes by any one of the three that affect its agricultural exports could influence the markets for the others. Thus the policy emphasis of the United States has been on these countries.

Second, the scope of actions that can bring on a case goes well beyond GATT-proscribed activities. Indeed, none of these cases involved claims of GATT violations, and none led to the use of the GATT dispute settlement mechanism. Two of the cases, Brazil Informatics and Brazil Pharmaceuticals, did involve disputes over investment and intellectual property rights issues wherein international codes of conduct are currently being negotiated in the Uruguay Round. Thus, the use of Section 301 in these instances demonstrates the increasing willingness of the United States to anticipate the results of the GATT negotiations by writing its own rules of "acceptable" conduct in these aspects of trade policy and attempting to force compliance of these rules on other countries.

The Argentina Soybeans case illustrates that the United States is fully prepared to dictate rules to other countries that it routinely violates at home; its chief complaint was the differential export tariff imposed by Argentina. This tariff clearly conforms to the principle of maintaining positive effective rates of protection on higher value-added goods; a practice identical in effect to escalating import tariffs by stages of processing. Such tariff escalation is common in the United States.[11]

The Argentina Soybeans case is interesting for several other reasons. It illustrates the lack of economic analysis that goes into the construction of a case or the decision to initiate an investigation. In particular, recall that the case involved a claim that Argentina's export tariff system helped contribute to a loss of U.S. market share in third-country markets. Clearly, if Argentine producers were able to undersell U.S. firms despite having to pay a 16.5 percent export tariff, it seems only logical that the Argentines would have an even greater market share in the absence of such taxes. Even if the doubtful analysis of NSPA had theoretical merit, the USTR initiated an investigation without any empirical evidence of a relationship between Argentine tariff policies and world market conditions. Indeed, the law does not require that any such evidence ever be provided by petitioners in the case.

In addition, the case illustrates the ability of powerful sectors in the U.S. economy to influence U.S. policy. Indeed, the support of the soybean growers' lobby for this case rested on a U.S. negotiating

11. See, for example, Table 6.7 in Husted and Melvin (1990, pg. 178).

target of closing the tariff differential by raising the lower of the two tariffs, thus making "voluntary" export restraint an unstated but clear goal of the petition. Their direction guided some of the early goals of the bilateral consultations. It is ironic, however, that the ultimate resolution of the case through the lowering of the export taxes (and their differential) clearly helped the Argentine economy and hurt both elements (growers and processors) of the U.S. soybean industry.

The examples above illustrate one final point concerning U.S. trade policy. The issues raised by the U.S. government clearly produced acrimony on both sides. The atmosphere surrounding the discussions has been heated, with the U.S. side often claiming that promises that had been made were later broken. In these cases, the United States has been willing to raise the stakes in the dispute by self-initiating cases; it has repeatedly threatened retaliation and has imposed it on several occasions. It has refused to allow considerations such as the level of economic development in these countries to serve as an excuse for policies it considers unfair.

Economic Analysis of Section 301

Despite its recent prominence as a major tool of U.S. trade policy, relatively little theoretical or empirical analysis has been devoted to the topic. One exception is McMillan (1990) who argues that both the distributive and the efficiency impacts of Section 301 can be understood in the context of a simple game of dividing a dollar.[12] Suppose that there are two bargainers, A and B, who seek to divide $1 between them. If they agree, A receives z, which he values at rz ($r>0$) while B receives 1-z, which B values at 1-z. Bargaining proceeds in sequence, with A making an offer, followed by a counteroffer from B if B rejects the first. The process of alternating offers can continue indefinitely; however, at each step there is a small but nonzero probability that bargaining might break down forever. Should that occur, then the fallback levels of utility for A and B are f_a and f_b, respectively.

If each player is fully rational in his expectations about the behavior of the other and information on both sides is perfect, then the unique equilibrium outcome to this game is that A receives a payoff of $[r + f_a - rf_b]/r2$ and B receives $[1 + f_b - (f_a/r)]/2$. As the equilibrium to this game clearly illustrates, each bargainer's payoff rises the larger his own fallback position and falls the larger his opponent's. In other words, the options available in the event of the collapse of negotiations affect the terms of the agreement. This illustrates how the retaliation authority provided to the USTR by Section 301 is designed to improve the negotiating position of the United States. That is, retaliation by country A in the event of a collapse in negotiations would lower f_b, improving A's bargaining position. In contrast, counterretaliation by B would lower f_a and A's ultimate payoff. As the model also clearly shows, the more A values its payoff from the game (i.e., the larger the value of r), the stronger is A's bargaining position.

These dynamics help us to understand some implications about the use of Section 301. First, the relatively large proportion of Section 301 cases that have been aimed at Latin American countries and several developing countries of Asia could well be due to the fact that these countries export a disproportionate share of their output to the United States. Thus, U.S. retaliation against these countries would clearly damage their fallback positions. In addition, these countries have limited ability to counterretaliate credibly against U.S. commerce. Thus, the United States knows going into the dispute that it is bargaining from a position of strength and is prepared to use it to achieve its goals. The model

12. McMillan attributes this game to Binmore, Rubenstein, and Wolinsky (1986).

also suggests that the United States is likely to be most successful if it picks targets where the cost to foreigners of ending the practice is relatively small. As McMillan notes, this could lead to negotiated bilateral solutions that divert trade in favor of the United States rather than truly opening markets to global competition.[13]

A major assumption of the model described above is that information is perfect. In real situations, however, this is unlikely to be the case. Various game theoretic models of bargaining show that when negotiators have private information, the likelihood rises of either a breakdown in negotiations or an extension of the length of time required to reach a solution. This is because negotiators attempt to benefit from their private information. Thus, the existence of privately held information may lead to an inefficient outcome, including retaliation.

The most recent theoretical work on Section 301-type policy mechanisms is by Eaton and Engers (1992). This paper describes how threats and/or the imposition of international sanctions affect the behavior of the target country. More precisely, the paper assumes the existence of a country, S, that seeks to encourage a certain level of behavior, a, of another country, T, by threatening and then possibly imposing economic sanctions, s, on that country. Utility in S (in T) is an increasing (decreasing) function of a. Utility in both is decreasing in s. Parties interact by making alternate moves. S begins by announcing a desired level of a that it wants T to pursue. T then decides whether it will comply. Then S decides whether or not to impose sanctions, and so on.

There are many possible equilibria to games of the sort the authors explore. They focus on the limit of finite horizon equilibria and show that equilibria exist which sustain a narrow range of possible levels of action by the target country. This range could include zero action and/or full compliance. The width of the range depends upon each party's toughness in terms of its willingness to bear the cost of sanctions. In general, the more patient is a party and the tougher it is, the better it does. As was the case with McMillan's model, this analysis suggests that sanctions may be most effective when the target's gains from trade are large and the sender's small. Thus, Section 301 may be more effective when aimed at major U.S. trading partners than against countries such as India that do not trade extensively with the United States.

The feature that differentiates the Eaton and Engers model from McMillan's is the fact that in the former the imposition of sanctions lowers the utility of the sanctions-imposing country. This is clearly the case in the real world, wherein the United States has repeatedly demonstrated restraint in its use of Section 301 sanctions. As noted above, the United States has often been reluctant to impose sanctions, and, in several circumstances, it has lifted them on the promise of a change in behavior.

The paper also shows that a threat of sanctions may be sufficient to induce the desired behavior. Indeed, Milner (1990) and Hudec (1990) document how the initial implementation of Super 301 and

13. The example that McMillan cites is the settlement of a 1985 case between Korean and the United States over trade in insurance. The settlement merely guaranteed greater market access for two U.S. firms. Another example is the semiconductor agreement signed in 1986 between the United States and Japan. Among other things, this agreement called for foreign market share to rise in Japan to 20 percent of semiconductor sales within five years. When the United States retaliated in 1987 over violations of the agreement it complained that U.S. market share was not growing at a rate sufficient to achieve the market share target. For more on the trade diverting aspects of Section 301, see Bhagwati (1988), especially pp. 124-125.

Special 301 induced several countries to undertake trade liberalization and protect intellectual property rights in order to avoid being targeted by the United States.

Section 301 in the Context of a Free-Trade Area

Dispute Settlement in the CUSFTA

A major goal for Canada in the negotiation of the CUSFTA was to establish an institutional framework that would insulate Canada from what it considered to be the vagaries of U.S. trade policy.[14] In the end, the CUSFTA did not change the trade laws of either country. However, the agreement did create two dispute-settlement mechanisms designed to arbitrate disagreements.[15] One of these mechanisms, Chapter Nineteen, permits the formation of binational panels to arbitrate disputes that arise over the operation of antidumping or countervailing duty laws in either country. With one additional exception, Chapter Eighteen of the CUSFTA provides for a mechanism for addressing all other disputes that might arise between the United States and Canada on the implementation and operation of the CUSFTA or on any action taken by either that is viewed by the other to nullify or impair any benefit that country expected under the agreement.[16] Thus, Chapter Eighteen offers a forum for reaching bilateral settlement of many Section 301 cases.

Chapter Eighteen provides for the creation of the Canada-United States Trade Commission (CUSTC) composed of representatives from both countries and headed by the principal government officials in charge of trade policy. The CUSTC examines any measure that affects the operation of the agreement and that cannot be solved in bilateral consultations. If the CUSTC cannot resolve the problem within 30 days it may refer the dispute to a panel for arbitration. The panel is composed of five members, two of whom must be from the United States and two of whom must be from Canada. The fifth panelist serves as chairman and can be from either country. Panelists are chosen from a roster of prospective members maintained by the CUSTC. Once the panel is appointed, each side has the right to at least one hearing before the panel as well as the opportunity to provide written submissions and rebuttal arguments. Unless previously agreed, the panel has three months to present an initial report containing findings of fact; its determination as to whether the measure at issue is or would be inconsistent with the obligations of the agreement; and its recommendations, if any, for resolution of the dispute. The panel may also provide preliminary estimates of the trade effects of the measure at issue.

Following the initial report, each country has two weeks to provide comments; these comments or any additional panel findings may be incorporated into a final report that is to be delivered to the CUSTC within 30 days of the initial report. If mutually agreed upon, the arbitration process is binding for both sides, with the panel report providing the basis for a solution to the dispute. If not, the panel recommends a solution to the CUSTC, which in turn is required to resolve the problem. In the event

14. For more on the Canadian perception of U.S. trade policy, see Rugman (1988).

15. Bello et al. review the operation of these mechanisms from their inception through mid-1991.

16. Bilateral disputes over the operation of financial institutions other than insurance companies are handled under a separate mechanism (Chapter Seventeen) also established in the agreement.

that all mechanisms fail, either party can withhold benefits of equal effect or terminate the agreement upon six months' notice.[17]

Cases Involving Canada

Canada has been the target of eight Section 301 cases. The three most recent have been initiated since the inception of the CUSFTA or have made use of the CUSFTA dispute-settlement mechanism. Consequently, these cases are useful in understanding how the United States utilizes Section 301 with a partner country of a free trade agreement; a description of the cases follows .

Case #55: Canada Fish. On April 1, 1986, Icicle Seafoods and nine other companies with fish processing facilities in Washington and southeastern Alaska filed a petition with USTR alleging that Canada's prohibition of exports of unprocessed sockeye salmon, pink salmon, and herring were in violation of GATT Article XI, which prohibits most export restrictions. The USTR initiated an investigation on May 16, 1986, and conducted several bilateral consultations with representatives of the Canadian government. These consultations failed to provide a satisfactory resolution to the issue, and the case was referred to the dispute settlement mechanism of GATT. Canada argued before the dispute settlement panel that while its export restrictions did indeed violate GATT Article XI, they were integral to Canada's west-coast fisheries conservation and management regime. Canada maintained that its policies were covered by GATT Article XX, which allows measures relating to the conservation of exhaustible resources. The United States won a favorable panel decision from GATT in 1988; this decision was adopted by the GATT Council in March 1988.

Although Canada announced in March 1988 that it would not oppose the panel decision, it maintained the claim that its policies were based on legitimate fishery conservation and management concerns. Hence, it declared that as of January 1989 it would replace the export ban with a landing requirement system that would be consistent with the GATT. This new system called for landing and inspection of all fish prior to export. In August 1988, the USTR informed the Canadian government that the proposed requirements would not satisfactorily remedy Canada's GATT violation since they would be inconsistent with the GATT as well as the CUSFTA, which was then pending entry into force.

Canada delayed repeal of its export ban, and in March 1989 the USTR determined that the ban denied the United States a right to which it was entitled by the GATT. At the same time, the USTR called for a public hearing to be held in April 1989 to consider possible trade actions against Canada as a result of this determination. One day before the public hearing, the Canadian government repealed its export prohibition and replaced it with regulations requiring all Pacific roe herring and salmon caught in Canadian waters to be brought to shore in British Columbia prior to export. In an exchange of letters during the following month, the United States and Canada agreed to submit Canada's policy of landing requirements to a CUSFTA dispute panel.

17. For more on the operation of the dispute settlement mechanisms under the CUSTA, see Anderson and Rugman (1990) and (1991).

In October 1989, the panel issued its final report, in which it found that Canada's 100-percent landing requirements violated CUSFTA Article 407, which prohibits GATT-inconsistent export restrictions. The panel's report was not binding; it did contain several alternative solutions available to Canada. One alternative, the panel said, was the imposition of more limited landing requirements to the extent justified in particular areas on conservation grounds. Based on the panel report, the USTR determined that the landing requirements denied U.S. rights under the CUSFTA.

On February 23, 1990, the CUSTC decided upon an interim settlement of the dispute. The principal elements of the Commission's decision were that the United States would be guaranteed a 25 percent share of at-sea exports of Canadian herring and salmon and that the fish exported directly to the United States would be subject to at-sea verification and sampling. Based on this settlement, the USTR terminated its Section 301 investigation in June 1990.

Case #80: Canada Import Restrictions on Beer. During the negotiation of the CUSFTA, neither side could convince the other to lower existing barriers on international trade in beer. Instead, the agreement grandfathered state and provincial laws regulating beer trade in place at the time, with both sides agreeing not to erect new barriers. On June 29, 1990 the USTR initiated an investigation of complaints by G. Heileman Brewing Company, Inc. that Canada's import restrictions on beer--including listing requirements, discriminatory mark-ups, and restrictions on distribution, were inconsistent with the GATT and the CUSFTA. In September 1990, the Stroh Brewing Company filed a petition complaining about the distribution and pricing practices of Ontario with respect to imported beer. In October 1990, the USTR decided to incorporate these additional complaints into its ongoing investigation.

At the heart of this case is the authority over liquor control given to individual provinces by the Canadian government. Provincial liquor boards have monopoly on the importation of beer and other alcohol into a province, whether from a foreign country or any other province. Canadian importers and consumers cannot bypass the provincial board by importing directly. Each province requires licenses to manufacture, keep, or sell beer in its territory. With the exception of two provinces, imported beer must be sold to local liquor boards, which in turn require or arrange delivery to their own central distribution centers. Retail prices of beer include customs duties and federal and provincial taxes, as well as various mark-ups determined by the boards. Mark-ups, charges, and minimum pricing arrangements are sometimes applied differently between imported and domestic beers.

In February 1991, the U.S. complaint was referred to a GATT dispute settlement panel.[18] The United States asked the panel to declare the Canadian beer practices contrary to GATT articles II (security of tariff concessions), III (national treatment), XI (elimination of quantitative restrictions), and XVII (operation of state trading enterprises). In October 1991, the panel released a report finding several of the provincial liquor practices to be inconsistent with the GATT. In January 1992, the USTR determined that the United States had been denied rights entitled to it under the GATT and requested comment on possible trade actions.

18. The United States chose to take its complaint to the GATT rather than the CUSTA dispute settlement mechanism because existing provincial barriers had been grandfathered into the CUSTA.

In April 1992, the United States and Canada reached an agreement to settle their dispute over provincial beer practices. However, before the agreement could be implemented, Ontario announced a 10 cent per can tax on beer sold in the province. Since most Canadian beer is sold in bottles while most imported beer is sold in cans, the tax fell more heavily on imports. The Ontario government also announced a $2.53 per case warehouse charge on imported beer. The U.S. government protested these new taxes; in July 1992, it retaliated with trade sanctions of $2.60-$3.00 per case on beer imported from Ontario. On the same day that these duties were announced, the Canadian government countered with comparable tariffs on U.S. beer imports. Both tariffs remain in place.

Case #87: Canada Softwood Lumber. The Canada softwood lumber case arose over a disagreement over the enforcement of a settlement to a 1986 countervailing duty (CVD) casein which a group of U.S. lumber producers filed a complaint with the U.S. Department of Commerce (USDOC) and the U.S. International Trade Commission (USITC) alleging that the low fees charged by Canadian provinces to clear timber from government lands represented an implicit subsidy to Canadian lumber producers. Before the case was completed the two countries signed a memorandum of understanding that called for Canada to collect a 15 percent *ad valorem* export tariff on softwood lumber exports to the United States.[19]

Over time, various provinces instituted "replacement measures" (including increases in stumpage fees) that served to shift the costs of Canadian timberland maintenance to the Canadian lumber industry. As these measures were introduced, Canada, with the approval of the United States, began to lower its export tariff by an equivalent amount. By 1987, the export tariff on lumber from British Columbia was zero, and by 1990 the USDOC agreed that the actions taken by Quebec had replaced all but 3.1 percent of the tax. As such, Canada announced in late 1991 that it was terminating the memorandum of understanding and thereby its collection of the export tax.

The USTR responded immediately to the Canadian action by self-initiating a Section 301 investigation against Canada and determining that the actions of Canada were unreasonable and burden on U.S. commerce. She instructed the Secretary of the Treasury to impose bonding requirements on Canadian softwood lumber imports on a province-specific basis at the *ad valorem* rates that had been collected by the Canadian government. This bonding requirement would remain in place until the completion of a CVD investigation by the U.S. government.

Subsequently, the USDOC and the USITC undertook a CVD investigation. The USDOC determined that the effect of various federal and provincial policies was to provide a subsidy of 6.51 percent on softwood lumber exports. The USITC found that the effect of this subsidy was to injure US lumber producers. Thus, a countervailing duty was introduced on Canadian lumber imports. The Canadian government protested these findings and appealed the case to a Chapter Nineteen panel under the CUSFTA. The panel ruled in favor of Canada.

19. A temporary import duty of 15 percent *ad valorem* was imposed by the United States for the ten day period between the signing of the memorandum of understanding and the date when Canada began collecting its export tax. The authority to impose this temporary tariff came from Section 301 (Case #58), when the President determined that the Canadian timber practices were an unreasonable burden on U.S. commerce.

Section 301 and the Negotiation of a WHFTA

Concerns of the United States

Each year since 1985, the Office of the USTR has published the *National Trade Estimate Report on Foreign Trade Barriers* (hereafter *Trade Estimates Report*), which provides official estimates of the degree to which foreign practices and policies act as a barrier to U.S. commerce; its publication is mandated by the Section 301 statute.[20] While not explicitly acting as a guide to current or future Section 301 actions, this document serves to indicate various national policies that may be of concern to the USTR. Moreover, it represents a guide to Congress, which monitors carefully the implementation of Section 301. The Senate Finance Committee recently requested the USITC to undertake an additional study of the current state of U.S. market access in Latin America, and in June 1992 the USITC released its findings.[21] The material contained in these documents spells out major objectives for the United States in any WHFTA negotiations; if these goals are not met, the chances of Congressional approval are greatly diminished.

According to these documents, the chief concern of the United States in its current commercial relations with Latin American is insuring adequate provision of protection for intellectual property rights (IPR).[22] Argentina, Chile, Colombia, and Venezuela are on the Special 301 "watch list" of countries that, in the view of USTR, do not provide adequate IPR protection. Brazil is one of only four countries on a Special 301 "priority watch list."[23] [24] In addition to these countries, the 1992 *Trade Estimates Report* was critical of the IPR policies of Ecuador, El Salvador, Guatemala, and Paraguay.

In any WHFTA negotiations, the United States can be expected to demand that Latin American countries adopt and enforce IPR protection measures at least as stringent as those recently undertaken by Mexico. Steps in that direction have recently been taken by Argentina, Chile, and the Andean Pact

20. The *Trade Estimates Report* attempts to provide an inventory of the most important foreign barriers to U.S. exports of goods and services and barriers affecting U.S. investment and intellectual property rights. This inventory is presented on a country by country basis and includes "if feasible" quantitative estimates of the impact of these policies on the value of U.S. exports. Much of this information is obtained from U.S. embassies and is anecdotal and highly suspect. This is especially true for the data contained in the first several reports. In addition, the report provides information on trade barriers in only a subset of the many trading partners of the United States. The Latin American countries discussed in the 1992 report are Argentina, Brazil, Chile, Colombia, Ecuador, El Salvador, Guatemala, Mexico, Paraguay, and Venezuela.

21. See United States International Trade Commission, *U.S. Market Access in Latin America: Recent Liberalization Measures and Remaining Barriers (With a Special Case Study on Chile),* Publication 2521, June 1992.

22. This has been confirmed in private discussions with representatives from USTR.

23. There are ongoing Section 301 cases against the IPR policies of the other three countries.

24. Canada is also on the "watch" list, largely because of its compulsory licensing provisions for pharmaceuticals. Mexico had been named to the first "priority watch" list in 1988. However, following enactment of legislation to modernize protection of patents, trademarks, and trade secrets, the USTR dropped Mexico from all Special 301 lists in April 1990. IPR protection has ceased to be an issue of contention between Mexico and the United States.

countries, but concerns remain in the U.S. government even in these cases. The United States is likely to push for agreements in a WHFTA that commit members to the IPR code negotiated in the Uruguay Round or to undertake equivalent obligations should the round fail.

Another area of major concern to the United States will be issues related to direct foreign investment. The U.S. can be expected to seek removal of limitations on foreign equity participation, and it also opposes various trade-related investment measures such as trade balancing requirements on foreign firms.

A final issue repeatedly cited in the *Trade Estimates Report* as a problem area for U.S. commercial interests are government procurement policies of countries such as Brazil and Colombia that discriminate in favor of locally produced goods. The United States is likely to seek more competitive procurement procedures and the elimination of discriminatory treatment for local suppliers.

Options for Negotiation

All of the problems mentioned above could become targets of future 301 actions and will without doubt be discussed in any WHFTA negotiations. Given that U.S. approval of any WHFTA pact depends in part on meeting at least some of the goals described above, an important question for the other WHFTA countries becomes, what institutions will they seek to put in place that will serve to arbitrate future disputes, thereby reducing the need for the United States to resort to Section 301 (or other trade remedies) and building political support for the agreement.

The importance of a strong dispute-settlement mechanism at the heart of a WHFTA cannot be overstated. Trade is much less important for the United States than it is for any other potential member of WHFTA. This fact strengthens the ability of the United States to use Section 301. As Hankey notes in his contribution to this publication, dispute settlement procedures "give the parties equal weight under the law of the agreement, and therefore should neutralize the power differential between them." Various aspects of dispute settlement mechanisms enhance this process; these aspects must be negotiated.

For instance, a crucial element of the mechanism will be whether the parties accept the recommendations of the panel process as binding or nonbinding. In the CUSFTA, dispute settlement decisions are binding only if both parties agree to treat them as such. The limited experience with the process to date suggests that both sides prefer nonbinding recommendations from panels, with ultimate settlement of disagreements fashioned by the politicians that make up the CUSTC. While nonbinding arbitration is more flexible, it reverses to at least some degree the balance of power that the mechanism is supposed to convey to the agreement. After all, if agreements are ultimately determined by the political process, then negotiators from the most powerful country involved in the dispute will have an upper hand in fashioning a resolution.[25] Thus, given that the United States, through its use of Section 301, is likely to be quite intrusive in attempting to alter foreign practices, equity interests would seem to argue for a binding panel process.

25. Anderson and Rugman (1990) are quite critical of the fact that none of the Chapter Eighteen cases decided to date have involved binding panel decisions. They write, "[W]hat is required is not politicization by putting the problem back into the hands of politicians, but rather a stronger independent body that can tell either federal government that a practice has to be changed." Anderson and Rugman, p. 41, footnote 168.

Another feature of the process that must be negotiated has to do with who is enfranchised by the mechanism. Neither GATT nor Chapter Eighteen of CUSFTA permits private parties to initiate dispute settlement cases against the practices of foreign governments. Thus, in those instances where U.S. firms feel that they have been hurt by foreign practices, they must first make their case to the U.S. government, which in turn initiates a Section 301 investigation. Contrary to the goals of the statute, the initiation of a Section 301 case by the U.S. government may exacerbate tensions and slow down the process of achieving an agreement. This is especially true in those instances where past trade disputes with the United States have been rancorous. If private parties were allowed direct access to the process, as under Chapter Nineteen of the CUSFTA, the use of Section 301 would likely be limited to the most egregious cases where the weight of the U.S. government in reaching a settlement would be viewed as essential.

Another way to reduce international frictions is to initiate dispute settlement earlier in the process. Panels could be established at the onset of bilateral consultations, rather than after a political impasse is met.[26] Finally, if parties to the dispute were asked to calculate the net benefit to both producers and consumers in both countries from eliminating the offending practice, panels could incorporate these details into the decision-making process and frivolous complaints might be deterred.

Conclusion

Section 301 of U.S. trade policy authorizes the USTR to negotiate the elimination of foreign government practices viewed by the United States to affect U.S. commerce adversely. Along with negotiating authority, the statute empowers the USTR to order trade retaliation against recalcitrant countries. Since its inception in 1974, Section 301 has been a source of conflict and controversy between the United States and some of its trading partners; its use to open foreign markets has been widely labeled as "aggressive unilateralism."

This paper has sought to discuss the role of Section 301 in current U.S. trade policy and to speculate about the role this statute might play in the context of a WHFTA. The paper reaches the following conclusions.

First, Section 301 will not disappear even after a WHFTA is put in place. The United States has began two cases against Canada between 1989 and 1991, and used the dispute-settlement mechanism in the CUSFTA to settle third case. Moreover, Section 301 is extremely popular in Congress. Future trade legislation may strengthen some of its provisions, and the Clinton administration is likely to make greater use of existing authority. However, it is extremely unlikely that the United States would ever be so unrestrained in its use of Section 301 as to threaten or undermine international agreements such as GATT or the CUSFTA.

Over time, disputes will arise between the United States and one or more of its WHFTA trading partners. Consequently, a well-functioning dispute mechanism is a necessary part of any WHFTA. Such a mechanism would balance the unequal economic power of the United States with its trading partners. In such a mechanism, Section 301 would serve as a vehicle for bringing a U.S. complaint to a dispute panel. If the dispute process is widely viewed as fair and above politics, then U.S. interests can be served while tensions are defused.

26. This change in the process has been suggested by Bello et al. (1991).

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Section 301 Cases

Case #	Target Country	Date Filed	Self-Initiated[a]	Date Resolved	Nature of Case	GATT consultations	Retaliation[b]
1	Guatemala	7-1-75	No	6-29-76	cargo restrictions	No	
2	Canada	7-17-75	No	3-14-76	egg import quotas	No	
3	EC	8-7-75	No	7-21-80	import levies on eggs	No	
4	EC	9-22-75	No	1-5-79	min. prices/ canned goods	Yes	
5	EC	11-13-75	No	6-19-80	malt export subsidies	No	
6	EC	12-1-75	No		flour export subsidies	Yes	Export Enhancement Program counter subsidies
7	EC	3-30-76	No	6-18-80	variable levy on sugar	Yes	
8	EC	3-30-76	No	1-5-79	cattle feed rules	Yes	
9	Taiwan	3-15-76	No	12-1-77	tariffs on appliances	No	
10	EC & Japan	10-6-76	No	12-9-78	deflection of steel trade	No	
11	EC	11-12-76	No	8-10-86	citrus tariffs	Yes	40% tariff on EC pasta
12	Japan	2-14-77	No	3-3-78	market access for silk	Yes	
13	Japan	8-4-77	No	12-85	leather quotas	Yes	raised tariffs & received trade compensation
14	USSR	11-10-77	No	7-12-79	marine insurance monopoly	No	
15	Canada	8-29-78	No	10-30-84	taxes on U.S. advertising	No	enacted mirror legislation
16	EC	11-2-78	No	8-1-80	wheat export subsidies	No	
17	Japan	3-14-79	No	1-6-81	import restrictions/cigars	Yes	
18	Argentina	5-25-79	No	7-25-80	marine insurance monopoly	No	
19	Japan	10-22-79	No	1-6-81	pipe tobacco restrictions	Yes	
20	Korea	11-5-79	No	12-29-80	market access (insurance)	No	
21	Switzerland	12-6-79	No	12-11-80	eyeglass standards	No	
22	EC	8-20-81	No	6-28-82	sugar export subsidies	Yes	
23	EC	9-17-81	No		poultry export subsidies	Yes	
24	Argentina	10-9-81	No	11-16-82	breach of hides agreement	No	ended agreement & raised tariffs
25	EC	10-16-81	No	9-15-87	pasta export subsidies	Yes	imposed tariffs
26	EC	10-23-81	No	12-1-85	canned fruit prod. subsidies	Yes	
27	Austria	12-2-81	No	7-20-83	specialty steel subsidies	Yes	negotiated voluntary export restraint (VER)
28	EC (France)	12-2-81	No	7-20-83	specialty steel subsidies	Yes	negotiated VER
29	EC (Italy)	12-2-81	No	7-20-83	specialty steel subsidies	Yes	negotiated VER
30	Sweden	12-2-81	No	7-20-83	specialty steel subsidies	Yes	negotiated VER
31	EC (U.K.)	12-2-81	No	7-20-83	specialty steel subsidies	Yes	negotiated VER
32	Canada	6-3-82	No	9-23-82	railcar export subsidies	Yes	became countervailing duty (CVD) case
33	EC (Belgium)	6-23-82	No	7-20-83	specialty steel subsidies	Yes	negotiated VER
34	Canada	7-27-82	No		subsidies: front-end loaders	Yes	
35	Brazil	10-25-82	No	11-85	shoe import restrictions	Yes	
36	Japan	10-25-82	No	12-85	shoe import restrictions	Yes	raised tariffs & received trade compensation
37	Korea	10-25-82	No	8-83	shoe import restrictions	No	
38	Taiwan	10-25-82	No	12-19-83	shoe import restrictions	No	
39	Korea	3-16-83	No	12-15-83	steel rope subsidies	Yes	
40	Brazil	4-16-83	No		soy products subsidies	Yes	
41	EC (Portugal)	4-16-83	No		soy products subsidies	Yes	
42	EC (Spain)	4-16-83	No		soy products subsidies	Yes	
43	Taiwan	7-13-83	No	3-22-84	rice export subsidies	No	
44	Argentina	9-21-83	No	5-25-89	air courier monopoly	No	
45	Taiwan	12-19-83	No	4-26-84	film distribution/access	No	
46	EC	5-25-84	No	5-21-85	satellite launching subsidies	No	
47	EC	8-17-84	No		fertilizer standards	Yes	
48	Japan	6-14-85	No		semiconductor barriers	No	raised tariffs

Case #	Target Country	Date Filed	Self-Initiated	Date Resolved	Nature of Case	GATT consultations	Retaliation
49	Brazil	9-16-85	Yes	10-6-89	informatics barriers	No	
50	Japan	9-16-85	Yes	10-6-86	local tobacco monopoly	No	
51	Korea	9-16-85	Yes	8-28-86	local insurance monopoly	No	
52	Korea	11-4-85	Yes	8-28-86	intellectual property rights (IPR)	No	
53	Argentina	4-4-86	No		soybean export taxes	No	
54	EC	3-31-86	Yes		ag import barriers/enlargement	No	raised tariffs and quotas
55	Canada	4-1-86	No	6-1-90	fish processing restrictions	No	
56	Taiwan	8-1-86	Yes	10-1-86	customs valuation	No	
57	Taiwan	10-27-86	Yes	12-5-86	beer/wine/tobacco laws	No	
58	Canada	12-30-86	Yes	1-8-87	softwood lumber subsidies	No	
59	India	1-6-87	No	5-88	almond quotas	Yes	
60	EC	7-14-87	No		meat processing standards	Yes	
61	Brazil	6-11-87	No	6-27-90	IPR: drug patents	No	raised tariffs
62	EC	11-25-87	Yes		beef hormones	Yes	raised tariffs
63	EC	12-16-87	No	1-31-90	oilseed subsidies	Yes	
64	Korea	1-22-88	No	5-31-88	cigarette barriers	No	
65	Korea	2-16-88	No	3-22-90	beef licensing system	Yes	
66	Japan	5-6-88	No	7-5-88	citrus quotas	Yes	
67	Korea	4-27-88	No	1-18-89	wine barriers	No	
68	Argentina	8-10-88	No	9-23-89	IPR: drug patents	No	
69	Japan	11-21-88	Yes	7-31-91	construction barriers	No	
70	EC	11-14-88	No	2-26-90	zinc export controls	Yes	
71	EC	5-8-89	Yes	10-1-89	canned fruit subsidies	No	
72	Thailand	4-10-89	No	11-23-90	tobacco barriers	Yes	
73	Brazil	10-6-89	Yes*	5-21-90	import licensing	Yes	
74	Japan	6-16-89	Yes*	6-15-90	satellites procurement	No	
75	Japan	6-16-89	Yes*	6-15-90	supercomputers procurement	No	
76	Japan	6-16-89	Yes*	6-15-90	forest products barriers	No	
77	India	6-16-89	Yes*	6-14-90	investment barriers	No	
78	India	6-16-89	Yes*	6-14-90	insurance barriers	No	
79	Norway	7-11-89	No	4-26-90	gov't procurement: toll equip	Yes	
80	Canada	5-15-90	No		beer barriers	Yes	raised tariffs
81	EC	11-15-90	Yes	12-21-90	EC enlargement agreement	Yes	
82	Thailand	11-15-90	No		IPR: motion pictures	No	
83	EC	11-28-90	No		meat standards	Yes	
84	Thailand	1-30-91	No		IPR: drugs	No	
85	India	5-26-91	Yes**		IPR	No	
86	China	5-26-91	Yes**		IPR	No	
87	Canada	10-4-91	Yes		softwood lumber subsidies	No	CVD case initiated; duties imposed
88	China	10-10-91	Yes		market access	No	

Source: *International Trade Reporter: Import Reference Manual*. Washington D.C.: The Bureau of International Affairs, Inc., 1992, Section 49.

Notes:
a. *Super 301 Case; **Special 301 Case
b. Retaliation is broadly defined by the author to include various measures including other forms of U.S. trade policies.

ANTIDUMPING AND COUNTERVAILING DUTIES IN A WESTERN HEMISPHERE FREE TRADE AGREEMENT

Heather A. Grant and Gilbert R. Winham

Introduction

The use of antidumping (AD) duties and countervailing duties (CVDs) to prevent or remedy unfair trade practices has been an important issue during recent multi- and bilateral trade negotiations. Parties differ on the role they believe remedies to unfair trade practices should play in trade policy, and this disagreement has led to inconsistent applications of these remedies. The result is an "uneven playing field" for trading partners.[1] It has become evident that more standardized rules and procedures governing the application of these remedies are required. Other measures must be considered for inclusion in regional agreements to achieve the desired security of access to a trading partner's market in order to foster economic growth in a competitive environment.

The application of AD duties and CVDs by the United States was one of Canada's major grievances during the negotiation of the free trade agreement (CUSFTA) with the United States.[2] Initially Canada tried to gain a blanket exception from U.S. trade remedy laws, but this was unobtainable. As an alternative, Canada placed considerable effort on negotiating a dispute settlement mechanism into the CUSFTA that would in particular reduce Canada's exposure to the use of AD duties and CVDs by the United States.

The dispute settlement mechanism ultimately incorporated into Chapter 19 of the CUSFTA provides for the judicial review of AD duty and CVD actions by means of binational panels.[3] More specifically, it provides exporters and importers the option of taking a disputed AD or CVD action to a binational panel with binding powers in lieu of seeking judicial review by a domestic court. Because individuals from both the United States and Canada sit on the panels, it is generally assumed that binational panels promote greater consistency and objectivity in AD and CVD cases. Perhaps because of these characteristics, it has been one of the most successful dispute settlement mechanisms developed in recent years.

There is no question that the initiation of a AD or countervailing action as well as the imposition of a duty can have serious consequences for exporters or importers. Given the seriousness of the interests at stake, combined with the tendency toward increasing use of unfair trade remedies, it is important that consideration be given to negotiating an CUSFTA-like mechanism for the resolution of AD and CVD disputes into a prospective WHFTA.

1. J. Michael Finger and Andrzej Olechowski, eds., *The Uruguay Round: A Handbook for the Multilateral Trade Negotiations*, Washington, D.C.: The World Bank, 1987, p. 155.

2. Gilbert R. Winham, *Trading with Canada: The Canada-U.S. Free Trade Agreement*, New York: Priority Press Publications, 1988, p. 38.

3. CUSFTA, Article 1904.

The success of the CUSFTA Chapter 19 mechanism leads somewhat obviously to its consideration as a model for a WHFTA. What remains at issue is whether this mechanism can be applied effectively in a considerably broader trade agreement such as a WHFTA, given the differences that exist between the legal and administrative practices of the prospective negotiating parties. The purpose of this paper is to examine some of the obstacles to and implications of extending the CUSFTA's Chapter 19 dispute settlement mechanism to a WHFTA by using Mexico as a reference point for the discussion. Mexico is chosen because the negotiation of Chapter 19 in the North American Free Trade Agreement (NACUSFTA) raised many of the problems that may later require solution either in extending NACUSFTA to new members or in creating a broader hemispheric trade agreement.

To appreciate the significance of a Chapter 19 mechanism for a WHFTA or NACUSFTA, it is first necessary to examine the historical development of AD and CVD actions in international trade. The purpose of this review is twofold. First, it serves to set out the basic tenets underlying the creation of these measures to remedy unfair trade practices. Second, it illustrates the parallel between Canada's bargaining position under the CUSFTA to that of Mexico and other WHFTA nations vis à vis the United States. A discussion of the major provisions of Chapter 19 and its application to date follows the historical analysis.

History and Development of AD and CVDs

One of the primary objectives of the GATT is to promote secure access to foreign markets so that businesses will have confidence that when they export their products they will not encounter unfair or unforeseen impediments in competing for a portion of the consumer market. Dumping and unrestricted subsidization have long been recognized as serious obstacles to this objective. Dumping is generally understood as the sale of goods on a foreign market at a price less than that at which the product is sold on the seller's domestic market, whereas a subsidy is the granting of a benefit, usually by a government, at any stage of a good's manufacture, production, or export.

General concern about the harmful effects of dumping and subsidization resulted in their inclusion in the GATT negotiations in 1947. These negotiations concluded with the insertion of a remedy under Article VI of the Final Agreement, which allows CPs to the GATT to take unilateral action to offset the effects of dumping or subsidies on their domestic industry through the use of AD and CVDs.[4]

Article VI allows the application of an AD duty against an imported good when it is being dumped on the foreign market and is causing or threatening to cause "material injury to an established industry...or materially retard[s] the establishment of a domestic industry." A CVD may be applied to an imported good to offset the effects of a foreign subsidy when it also causes or threatens to cause injury to the domestic industry or impedes the potential development of such industry.

The GATT provisions for AD and CVDs represented minimal commitment to real control over these practices, and consequently these trade remedies became protectionist devices in themselves. This realization paved the way for the creation of Antidumping and Subsidies Codes during the Kennedy and Tokyo Rounds in 1969 and 1979, respectively. The purpose of these Codes was to define more precisely

4. John H. Jackson and Edwin A. Vermulst, eds., *Antidumping Law and Practice: A Comparative Study,* Ann Arbor: The University of Michigan Press, 1989, p. 6.

the conduct expected of CPs in their investigation and assessment of dumping and subsidy practices so that the free flow of goods was not jeopardized by their unfair use.

The first Antidumping Code, concluded in 1967, was replaced in 1979 by a new Code[5] that sets out more explicit requirements governing a country's conduct of its antidumping and injury investigations, and the application of duties or price undertakings. The new Code has been largely successful in achieving a greater standardization of antidumping practices among CPs.[6]

In contrast, the Subsidies Code,[7] also negotiated during the Tokyo Round, has not been as useful in standardizing world practice. Like the Antidumping Code, the Subsidies Code imposes some greater procedural requirements upon signatories with respect to evaluating subsidies and assessing CVDs. However, owing to the conflict between trading nations on the legitimacy of subsidies in domestic economies, and hence a lack of cooperative support, the Subsidies Code is essentially weak international law. Moreover, unlike the Antidumping Code, the Subsidies Code has not yet been incorporated into GATT, although signatories are obliged to implement its provisions into their domestic laws.[8]

Whereas dumping is generally considered an unfair practice, all forms of subsidies are not necessarily considered unfair and therefore countervailable. In its preamble, the Subsidies Code recognizes the dual nature of subsidies: they can be instrumental in promoting important domestic policy objectives, while at the same time possibly harming a foreign industry's competitiveness. The Code's objective in defining when and how a subsidy may be countervailed is to balance the harm of a subsidy against the injurious effects of a CVD.

As between member states, there is considerable disparity in the application of subsidies and CVDs.[9] By far the most important country on this matter is the United States. The U.S. government takes a strong position opposing the use of subsidies, and it has been the most frequent user of the CVD mechanism in an effort to protect U.S. producers from competition with subsidized imports. Subsidies and CVDs therefore become important trade issues for nations with extensive trade with the United States.

5. Officially titled Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade.

6. Finger and Olechowski, *ibid.*, p. 156.

7. Officially, Agreement on Interpretation and Application of Article VI, XVI, and XXIII of the General Agreement on Tariffs and Trade.

8. Other Latin American and Caribbean states that signed the Subsidies Code in 1979 are Brazil, Chile, and Uruguay.

9. J. Michael Finger and Julio Nogués, "International Control of Subsidies and Countervailing Duties," *The World Bank Economic Review* 1:4, p. 712.

United States Policy on AD Duties and CVDs

As a signatory to both Codes, the United States implemented the provisions of each through the Trade Agreements Act (TAA) of 1979. The Act restructured the U.S. unfair trade remedy system in a politically significant manner. From 1954 to the enactment of the TAA, bureaucratic responsibility for the trade remedy system had been divided between the Treasury Department, which made determinations of dumping or subsidy, and the International Trade Commission (ITC), which handled determinations of injury. In 1979, responsibility for the former was shifted to the International Trade Administration of the Department of Commerce. Since that department was perceived as being more sympathetic to importers than the Treasury Department had been, this was widely regarded as a move to facilitate the use of trade remedies by U.S. constituents.[10]

Title VII of the TAA incorporated the Tokyo Round Antidumping Code into U.S. domestic law, but in the process several modifications were made. First, enhanced access to the information accumulated and used in AD duty cases was provided to importers and exporters of goods under investigation. Second, regional markets were given standing to initiate AD cases. Third, importers were given greater influence in negotiating undertakings by exporters in lieu of AD duties, and a fourth change made it easier for petitioners to initiate AD cases. The combined effect of these changes was to facilitate AD actions.

Regarding CVDs, the main impact of the TAA of 1979 was to incorporate the Tokyo Round Subsidy Code into U.S. legislation, and especially to introduce a material injury requirement into U.S. CVD practice. The obligation to demonstrate injury (on products coming from Subsidy Code signatories only) was an important change to U.S. producers, although it would appear that the requirement of "material" injury likely did not add much.[11] Other procedural changes in the TAA facilitated CVD petitions and administrative procedure.[12]

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10. Rodney de C. Grey, *United States Trade Policy Legislation: A Canadian View.* Montreal: The Institute for Research and Public Policy, 1982, 56.

11. Material injury was defined in the TAA as "harm which is not inconsequential, immaterial or unimportant," Section 771(7). Washington trade lawyer Matthew Marks has observed: "I can only conclude ... that the substitution of a material injury standard of simple injury under the Trade Act of 1979 has had little, if any, effect on the Commission's administration of the Anti-Dumping Act and countervailing duty law to date". Text of letter of 31 July 1980 of Matthew Marks to Rodney Grey, cited in Grey, *ibid.*, p. 46.

12. Prior to the TAA, the Trade Act of 1974 had expanded CVD procedures in U.S. law, especially regarding judicial review. The Act provided for a right of appeal to a Customs Court, which later became the Court of International Trade (CIT). Manufacturers and producers in the United States were given standing to pursue an appeal. Previously, only importers had that right. Additionally, parties were given the right to have judicial review of negative findings and to challenge the amount of a CVD finding in addition to the finding itself.

The Trade Act of 1974 both facilitated the use of CVDs and it improved the procedural safeguards associated with those procedures. For example, writing about the pre-1974 period, Stanley Metzger has noted, "[o]ne of the most striking aspects of countervailing duty administration in the United States is the almost total lack of procedural safeguards in official proceedings. Neither statute, nor regulations make any provision for hearings and the usual ancillary procedures according substantial elements of procedural due process to parties or countries affected by a countervailing duty imposition. The lack of procedural safeguards is peculiarly disturbing in view of the very great discretion delegated to the secretary of the treasury and, through him, to the Bureau of Customs."

The greater transparency in the rules and regulations, as well as procedural requirements governing AD and CVD actions incorporated into the TAA, made it easier for importers in the United States to petition for AD or CVD actions and to seek review of those actions through the judicial system. The result was a sharp increase in the number of actions launched by the United States since implementation of the amendments brought about by the TAA (and the Trade Act of 1974). Prior to 1970 the United States resorted to AD or CVD actions only occasionally; for example, as noted by Hart: "[b]etween the enactment of the final countervailing duty statute in 1897 and 1969, only some 65 countervailing duty orders were issued, roughly one a year."[13] This contrasts sharply with the situation immediately following passage of the TAA, where the United States initiated 280 CVD investigations over the period 1980-1985.[14] Against Canada, the United States initiated 11 new CVD cases over the period 1980-1987.

There are two approaches to the use of AD and CVDs. On the one hand, these measures can be seen as an attempt to remedy or offset unfair trade practices by foreign governments or exporters. As an alternative, they can be seen as a system of contingency protection, or "measures of 'stand-by protection' or techniques of administered trade."[15] Contingency protection is especially provided on the initiative of specific industries on the basis of a complicated body of trade regulations. The system is discrete and highly legalistic, and it is an alternative to a more general approach to trade policy based on multilateral tariff reductions or codes of conduct. The use of contingency protection—or trade remedies —increased in the 1980s, but whereas the incidence of AD duties is fairly evenly distributed between trading nations, CVDs are principally a U.S. policy instrument.[16] As aptly described by Patrick Messerlin, "[t]o the United States, the [Subsidies] [C]ode is an instrument to control subsidies. To the rest of the world, it is an instrument to control U.S. countervailing duties."[17]

Stanley D. Metzger, *Lowering Nontariff Barriers: U.S. Law, Practice and Negotiating Objectives,* Washington, D.C.: The Brookings Institution, 1979, 105.

13. Michael Hart, "The Future on the Table: The Continuing Negotiating Agenda under the Canada-United States Free-Trade Agreement." Paper presented at a conference held at the University of Ottawa, Faculty of Law (Common Law), May 5, 1989, p. 39.

14. Finger and Nogués, *ibid.*, p. 708.

15. Grey, *ibid.*, p. 8.

16. Finger and Nogués note that over 1980-1985, AD actions initiated by three GATT CPs were as follows: United States, p. 280; EC, p. 254; and Canada, pp.219, 708.

17. Patrick Messerlin, "Public Subsidies to Industry and Agriculture and Countervailing Duties." Paper prepared for the European Meeting on the Position of the European Community in the New GATT Round. Spain, October 2-4, 1986, as referred to in Finger and Olechowski, *ibid.*, p. 156.

The Canada-United States Free Trade Agreement

In view of the frequent use by the United States of unfair trade remedies during the 1980s, especially countervailing duties, Canada recognized the need to achieve more secure access to the U.S. market under the CUSFTA, given its high dependence on trade with the U.S. and the likelihood of its increased dependence in the future. Security of access therefore became one of the major goals of Canada in the CUSFTA negotiation.

During the negotiations Canada originally hoped to achieve an exclusion from the scope of U.S. unfair trade remedy laws. However, the United States never considered this proposal a serious option. Canada's alternate suggestion that a list of "acceptable" and "unacceptable" subsidies be established by the parties involved came to a similar impasse.

Canada's lack of success in negotiating the inclusion of either of these proposals into the CUSFTA led it to suggest the adoption of an interim dispute settlement mechanism in the belief that it would give Canada some indirect control over the use of U.S. trade remedy laws against Canadian goods. For Canada, the mechanism was fundamental to closing a deal. Had the proposal been rejected by the United States, Canada would not have signed the agreement. Only hours before the deadline, the United States agreed to a binding dispute settlement mechanism covering AD and CVDs.

Dispute settlement on AD and CVDs is included in Chapter 19 of the CUSFTA, and it has three parts. First, the parties agreed to continue negotiating on dumping and subsidy issues and to establish alternative rules within seven years, if possible. A working group was created to pursue this task, but both countries agreed to negotiate issues of dumping and subsidy/countervail in the multilateral Uruguay Round in lieu of bilateral talks.

Second, the parties agreed that amendments to either country's AD or CVD laws would be subject to constraints of notification and consultation, and that such amendments would be consistent with relevant provisions of the GATT and other multilateral accords, and the CUSFTA itself. In addition, parties agreed to submit proposed legislative changes to a binational panel (see below) for an advisory opinion on the consistency of the change with existing obligations under international law.

Third, the parties established binational panels to replace judicial review by domestic courts of final AD or CVD determinations by national agencies. Each party agreed to retain its own AD and CVD practices—which in any case were fairly similar—and to make available binational panels to persons who would otherwise have been entitled to judicial review under domestic law. The panel's mandate is to consider the administrative record of the case appealed and decide whether the final determination was made in accordance with applicable domestic law.[18]

Panels are composed of five members chosen from a roster of trade experts, primarily lawyers, established in each country. Two panelists are selected by each country, and the fifth is chosen jointly, or by lot when there is no agreement on the final member. In practice, the fifth member's nationality has alternated between the two countries from one panel to the next.

18. CUSFTA, Article 1902.

The standard of review to be applied by the panel is the standard applicable in the country where the AD or CVD was made. In Canada, the test is whether the agency (a) failed to observe a principle of natural justice or otherwise acted beyond or refused to exercise its jurisdiction; (b) erred in law in making its decision or order, whether or not the error appears on the face of the record; or (c) based its decision or order on an erroneous finding of fact that was made in a perverse or capricious manner or without regard to the material before it. In the United States the test is whether the agency's decision is unsupported by substantial evidence on the record, or is otherwise not in accordance with the domestic laws.[19]

It is important to note that the panels are not authorized to create substantive law but must act consistently with the laws of the importing country. Determinations of dumping and subsidization can be different in each country but will still be upheld as long as the administrative agency made its determination in accordance with domestic law.

Review of the panel's decision is very limited. There is no appeal mechanism in the CUSFTA to challenge a panel's findings on the grounds of legal or factual error. The extraordinary challenge procedures can be invoked only when there are allegations of gross misconduct, bias, serious conflict of interest, or other material violation of the rules of conduct by a panelist; or there is a serious departure from a fundamental rule of procedure by the panel; or if the action by the panel is manifestly in excess of its powers, authority, or jurisdiction; and when any of the actions outlined above materially affected the panel's decision or threatened the integrity of the review process.[20]

Through November 1992, 30 Chapter 19 cases and one Extraordinary Challenge had been initiated.[21] Of these, 24 were directed against U.S. agencies [the Department of Commerce (DOC) or the International Trade Commission (ITC)]. Fifteen of these cases have been completed and nine remain active. Six have been initiated against Canadian agencies [Revenue Canada (RC) or the Canadian International Trade Tribunal (CITT)]. Three of these cases have been completed, and three remain active. One of the six cases against Canadian agencies was launched by a Canadian petitioner, and the rest were brought by U.S. petitioners. All of the cases against U.S. agencies were brought by Canadian petitioners, although in seven of these, U.S. petitioners were also present. Overall, Canadians have been the major users of Chapter 19 procedures, and the main respondents have been U.S. agencies.

The results of Chapter 19 actions are that about half of the cases resulted in a remand in whole or in part; that is, the determination was returned to the agency for "action not inconsistent with the

19. CUSFTA, Article 1911 defines the standard of review. In Canada the standard of review under the CUSFTA is adopted from s.18.1(4) of the *Federal Court Act,* S.C. 1985, c.F-7 as amended, while the standard of review applicable in the United States is adopted from s.516A(b)(1) of the *Tariff Act of 1930.* See generally Gary Horlick and Amanda DeBusk, "The Functioning of the U.S.-Canada Free Trade Agreement Dispute Resolution Panels," in Leonard Waverman, ed., *Negotiating and Implementing a North American Free Trade Agreement,* The Fraser Institute, Toronto, 1992, 1; and, Stewart Abercrombie Baker, "Chapter Nineteen: The Antidumping and Countervailing Duty Laws," Unpublished Article, 1991.

20. CUSFTA, Article 1904.

21. Status Report of Cases (chapters 18 and 19) Canada-U.S. FTA Binational Secretariat, Canadian Section, November 1992.

panel's decision."[22] In the two Canadian cases that have been completed, the actions of the agency were affirmed in one panel and remanded in the other. For the completed U.S. cases, four were remanded and four were affirmed.[23] In the United States the Court of International Trade achieved approximately similar results in the period prior to the CUSFTA.

The overall judgment of the Chapter 19 mechanism is that the panel process has worked effectively. In a lengthy review of dispute settlement in the CUSFTA, Professor Andreas Lowenfeld of New York University has written that "[a]ll things considered, the unique binational dispute settlement mechanisms created by the Canada-United States Free Trade Agreement have worked extraordinarily well."[24] Lowenfeld notes that the panels have conscientiously applied the law of the country in which the case arose, and decisions have not reflected a bias for or against trade remedy legislation. Most important, panels have not reflected national bias, and panelists have dealt objectively with legal issues.

AD Duties and CVDs Under a NAFTA[25]

Like Canada in the CUSFTA negotiations, Mexico aimed to achieve greater and more secure access to the U.S. market by negotiating a NAFTA with the United States and Canada. In recent years, Mexico has increasingly found itself at the receiving end of U.S. AD actions.[26] Between 1980 and 1990, U.S. companies have initiated eight actions against Mexican producers.[27] Although AD practices have become more standardized among GATT members, there remains some discrepancy in their use and interpretation due to the lack of precision in the wording of the GATT's AD rules and procedures,

22. FTA, Art. 1904(8).

23. Cases can be remanded in whole or in part, hence a "remand" may be a relatively insignificant action.

24. Andreas F. Lowenfeld, "Binational Dispute Settlement under Chapters 18 and 19 of the Canada-United States Free Trade Agreement: An Interim Appraisal" Administrative Conference of the United States, December 1990, p. 78.

25. Michael Hart, *A North American Free Trade Agreement,* Ottawa: Centre for Trade Policy and Law, 1990, pp. 126-127.

26. Stephen J. Powell, Craig R. Giesse, and Craig L. Jackson, "Current Administration of U.S. Antidumping and Countervailing Duty Laws: Implications for Prospective U.S.-Mexico Free Trade Talks," 11 *Northwestern Journal of International Law and Business* (1990), p. 179. Mexico has not encountered the same problem with countervailing duty actions as Canada since it signed the "Understanding on Subsidies and Countervailing Duties" with the United States in 1986 and pursuant to its obligations under the Agreement, substantially altered its subsidy practice. See Celia R. Siac, "Does Mexico Subsidize too Much? Perceptions versus Reality," Toronto: C.D. Howe Institute Commentary No. 36, February 1992, p. 6.

27. These include: Carbon Steel Wire Rod; Oil Country Tubular Goods; Welded Steel Wire Fabric; Porcelain-On-Steel Cooking Ware; Certain Fresh Cut Flowers; Portland Hydraulic Cement; Certain Steel Pails and Gray Portland Cement & Clinker; taken from U.S. ITC Annual Reports 1980-1989.

although not to the same extent as with CVDs.[28] Binational review as exists in Chapter 19 of the CUSFTA can reduce the possibility of abuse by promoting the consistent application of domestic trade-remedy laws and regulations through the involvement of panelists from the countries that are party to the dispute. A Chapter 19-like mechanism could provide an adequate legal solution to an otherwise political problem.

However, even though the dispute settlement mechanism in Chapter 19 of the CUSFTA has worked well in a bilateral context between Canada and the United States, this success does not mean that it is necessarily suitable for NAFTA or other agreements. The extension of the CUSFTA's dispute settlement mechanism to Mexico raises a variety of obstacles and concerns. The purpose of this section is to discuss some of these obstacles and the implications of extending a Chapter 19-like mechanism to NAFTA. The following discussion is certainly not exhaustive, but it provides some indication of what problems or concerns were negotiated before agreement on this point was reached.

Before delving into the issues raised by the question of extending a Chapter 19 mechanism to NAFTA, it is useful to outline briefly the nature of Mexico's current unfair-trade-remedy system.

Mexico's AD and CVD System

Mexico's primary laws governing AD duty and CVD actions are the Foreign Trade Regulatory Act[29] (Act) and Regulations Against Unfair International Trade Practices (Regulations).[30] The agency responsible for AD and CVD actions is the *Secretaría de Comercio y Fomento Industrial* (SECOFI), a division of the Budget and Finance Ministry, with the *Comisión de Aranceles y Controles al Comercio Exterior* (CACCE)[31] providing consultative support, particularly on the issue of duty assessments.

SECOFI conducts up to two investigations leading to provisional duty assessments and a third culminating in a final determination. In order to make a positive finding, SECOFI must determine that an unfair practice (dumping or subsidization) exists in conjunction with a finding of injury to the domestic industry. Final affirmative determinations may be appealed by Mexican importers to the Federal Fiscal Tribunal (FFT) on grounds outlined in the *Código Fiscal* (Fiscal Code) such as incompetence of officials or a breach of formal requirements. In addition, the Mexican Constitution provides a supplemental remedy known as *amparo* that can be requested where a guaranteed individual right was breached during the administrative process and had an impact on the outcome of the action. The significance of the amparo procedure and remedy are discussed in greater detail below.

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28. William B. Carmichael, "Review of the Customs Tariff, (Antidumping) Act," Submission to the Gruen Review Canberra, 1986, as referred to in Finger and Olechowski, *ibid.*, p. 159.

29. Decreto por el que se Crea la Ley Reglamentaria del Artículo 131 de la Constitución Política de los Estados Unidos Mexicanos en Materia de Comercio Exterior, D.O., Jan. 13, 1986.

30. Reglamento Contra Prácticas Desleales del Comercio Internacional, D.O., Nov. 25, 1987.

31. CACCE can be translated as the Committee on Foreign Trade Tariffs and Controls. Ernesto Rubio del Cueto, "Countervailing Duties Affecting United States-Mexican Trade", 12 *Houston Journal of International Law* (1990) p. 323.

Mexico's AD provisions were invoked 35 times between 1987 and 1989. Fifteen of these cases were against U.S. imports, the majority initiated in 1987. Only four were initiated in 1988 and 1989, an indication of a decline in their use.[32] Mexico's CVD provisions have been invoked considerably less often, with only one case against Malaysia over the same time period.

Technical Issues of Incorporating Mexico Into a Chapter 19 System

From an organizational perspective, the extension of Chapter 19 provisions to Mexico raised both technical and substantive concerns. There are three technical impediments relevant to this discussion. First, the Chapter 19 mechanism of the CUSFTA was drafted in a bilateral context rather than in a trilateral or multilateral one. The question arose whether the mechanism should be amended to allow trinational (as opposed to binational) review. There are a number of forms such an amendment could have taken. One option, for example, was binational review by the parties directly involved in the dispute, with the third party having a right to participate in the hearing as a litigant but without national representation on the panel. This option requires relatively minor changes to the current structure and functioning of the mechanism. Trinational panel review may not be as appealing since the participation of a country not involved in the dispute could complicate rather than facilitate the decision-making process. In the end, binational dispute resolution was negotiated into the NAFTA.

The second and third technical issues are more serious and involve Mexico's Constitution. The second problem deals directly with Mexico's adherence to the Calvo Doctrine of law, which holds that legal disputes between Mexican and foreign business partners must be settled through Mexican internal remedies rather than international ones.[33] Some Latin American states, including Mexico, have adopted a provision in their constitutions that require foreigners who have been granted certain commercial rights to abstain from seeking the protection of their governments should a dispute arise. This clause raised the issue whether recourse to binational panels was valid under Mexican law, inasmuch as the panels might be perceived as granting a form of protection by a foreign government.[34] This provision did not pose a real threat to adopting binational review under NAFTA, however. It was effectively dealt with early in the Chapter 19 negotiations. In the context of a WHFTA, this issue will arise again: many Latin American states incorporate a form of Calvo clause in their constitutions.

The third technical problem involves Mexico's writ of amparo, which was mentioned earlier. The writ of amparo is a legal device that provides a process and remedy to redress violations of constitutionally protected individual rights that have caused a person injury.[35] Article 103 of Mexico's

32. USITC, *Review of Trade and Investment Measures by Mexico,* USITC Report No. 2275 (April 1990), pp. 4-17.

33. Dr. James C. Baker and Lois J. Yoder, "ICSID and the Calvo Clause a Hindrance to Foreign Direct Investment in the LDCs", 5 *Ohio State Journal on Dispute Resolution* (1989), p. 75.

34. Donald R. Shea, *The Calvo Clause: A Problem of Inter-American and International Law and Diplomacy,* Minneapolis: University of Minnesota Press, p. 6.

35. For an in-depth discussion of *amparo* see Hector Fix Zamudio, "A Brief Introduction to the Mexican Writ of *Amparo*" 9 *California Western International Law Journal,* (1979), 306-348.

constitution establishes the basis of recourse through an amparo proceeding, and Article 107 regulates its operation. In the context of AD and CVD actions, when all other remedies have been exhausted, the writ of amparo provides recourse for infringements of individual rights to due process by SECOFI, as established under Article 14 of the Constitution.

There appear to be two possible implications of this device for the adoption of binational review into NAFTA. First, amparo may be used to challenge the constitutionality of a law, such as whether binational review violates Article 27 of the Mexican Constitution (which requires recourse to Mexican institutions for resolution of disputes involving foreigners, i.e., the Calvo clause discussed above). If a court finds the law unconstitutional, it could conceivably invalidate the specific decision over which amparo was invoked without striking down the law itself.

The second implication of amparo on binational review involves more directly recourse to amparo for violations of individual procedural and substantive rights during the course of administrative proceedings, and not the constitutionality of the law under which a decision was made. In such cases, administrative reviews of SECOFI's final determinations by the Federal Fiscal Tribunal can be subject to review by district courts, collegiate courts, or the Supreme Court (depending on a variety of factors).

In administrative proceedings in the NAFTA context, the issues that arise are of a dual nature. One type involves the impact of amparo on the right to judicial review, where petitioners seek review of SECOFI's actions in domestic courts in place of binational review. For example, recourse to amparo would appear to be limited to Mexican importers and exporters, thereby excluding recourse by nonresidents. Furthermore, the grounds for review in an amparo action are not transparent. This lack of transparency makes it difficult for foreigner nationals to understand how the mechanism works and how the law is applied.

The second type, which is of far greater concern for binational review, is that the amparo process could undermine the finality of panel decisions. Because the right to petition review of an administrative decision under amparo is constitutionally entrenched, if a party meets the basic requirements to invoke amparo, it is likely that this remedy cannot be denied. If this is the case, decisions by binational panels would be subject to review by a superior domestic court. This review would negate one of the primary purposes of the binational panel, which is to be the final arbiter in an AD or CVD dispute.

Issues Raised by Chapter 19

Numerous substantive issues were also raised in the extension a Chapter 19-like mechanism to Mexico. Two required consideration. First, the CUSFTA mechanism in the trilateral context contemplates the application of Mexican law by the reviewing body to disputes involving the determination of an unfair trade practice. The problem can be stated in this manner: because of a common legal background in the United States and Canada, the dispute mechanism in Chapter 19 of the CUSFTA inherently contains certain standards applicable to due process and judicial review. However, concern was raised during the NAFTA negotiations that, because of the differing legal and administrative traditions in Mexico, the standards of due process and judicial review inherent in the functioning of the mechanism between Canada and the United States would be lowered in the trilateral context. Among other things, these concerns focused on the enforcement of deadlines, the suitability of the written record for judicial review, and the absence of potential bias in the administration of AD and CVD actions.

Second, there are specific differences between Mexico's trade-law administration and those of Canada and the United States. The Mexican administration is less favorable to affected parties than the Canadian and U.S. systems, and this discussion will highlight these differences in due course following a discussion of the potentially lower standard of due process and judicial review inherent in the application of Mexican law to trade disputes. The conclusion will describe how these issues have been dealt with in NAFTA.

It has been stated that the success of the CUSFTA's mechanism is largely due to the fact that Canada and the United States share similar legal traditions and unfair trade remedy systems. One of the overriding factors in the NAFTA situation is that the parties do not share a common legal tradition. Mexico's system is based on the civil law, whereas Canada and the United States have systems based on the common law. A general comparison between Mexican civil law and the common law in Canada and the United States is beyond the scope of this paper. For our present purposes it is sufficient to suggest that the approach to the application and interpretation of law in each of these systems is conceptually different and ultimately results in a disparity between the two systems.[36]

The differences between the two systems were not a barrier to extending Chapter 19 to NAFTA. However, the lack of experience of Mexican and American or Canadian lawyers and administrators with each other's legal systems would doubtless have generated some lack of confidence in the effectiveness of the panel process in NAFTA.[37] Although no transitional period was incorporated into the NAFTA Chapter 19 to ensure lawyers and officials adequate time to familiarize themselves with foreign procedures of judicial review, it appears likely that some time will pass before Mexico, in particular, has an opportunity to incorporate the changes to its unfair trade remedy rules and administration required under the NAFTA. The time lapse should help ensure a higher level of confidence in the mechanism all around.

A major problem as to whether a Chapter 19-like mechanism was suitable for NAFTA involved differences between the manner of conducting administrative proceedings in Mexico compared to the United States and Canada. In the United States and Canada it is considered extremely important to incorporate procedural safeguards into the structure and regulations governing the conduct of an administrative agency in order to protect individuals from potential abuse of state authority. When a superior body is asked to review the decision of an administrative body to see if it was made in accordance with law, this can include making a finding as to whether the agency acted outside the scope of its powers or whether it breached a procedural requirement, thereby affecting an individual's right to due process or natural justice.

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36. For example, while law is created under the common law by judges interpreting legislation in conjunction with cases establishing legal precedents, the civil law tradition is rule based, with limited authority given to judges to actually impose their own interpretation on the legislation. Civil law judges look at the text of specific rules to determine whether the text applies to a specific fact situation. Under the common law, judges have the power to modify or add to the law through the application of specific rules of interpretation. See Fernando Orrantia, "Conceptual Differences Between the Civil Law System and the Common Law System", 19 *Southwestern University Law Review,* (1990), pp. 1164-1165.

37. Peter Morici: "Trade Talks with Mexico: A Time for Realism", Unpublished Article, University of Maine, April 1991, p. 38.

As indicated earlier, the essence of Chapter 19 is that it requires a binational panel to assess whether an agency made its determination in accordance with domestic law. Consequently, if specific procedural safeguards governing the conduct of an agency's investigation and duty assessments are not incorporated into one party's administrative system, the result is a lower value of binational review for all parties involved in a dispute.

In Canada and the United States there are generally high standards of transparency, due process, and structural safeguards to guarantee an absence of bias in the decision-making process. These standards are incorporated into the conduct of administrative proceedings and ensure that decisions are made in a quasi-judicial manner. In Mexico, the standard of these three aspects of Mexico's trade remedy system are different and have serious implications for binational review.

Transparency

Transparency is a key element of the law governing the conduct of Canadian and U.S. administrative bodies. The standard of transparency in Canada and the United States generally requires that the law applicable to an administrative agency be clear and concise and accessible to the public. Furthermore, the agency's conduct in performing its duties must be evident so that its practice can be properly reviewed to determine whether the agency fulfilled its duties in accordance with the law.[38]

These same standards are not inherent aspects of Mexico's unfair trade law administration. Mexico's system is characterized by very general rules and regulations providing SECOFI with broad discretionary powers to perform its duties. SECOFI's powers of discretion emanate in part from the fact that there is limited transparency in how SECOFI's investigations and determinations of unfair trade practices are actually carried out. This fact has implications for the standard of judicial review under a Chapter 19-like mechanism.

More specifically, two examples highlight the absence of transparency and the problems this poses to the standard of review.

First, SECOFI's time frame for conducting its investigation and making its assessments does not reflect the one envisioned by the Regulations. In fact, numerous deadlines governing various stages of the proceedings are not adhered to. According to the law, SECOFI is required to initiate an investigation within five days of receipt of a petition. If it finds sufficient evidence to sustain a preliminary determination of dumping or subsidization in conjunction with an injury finding, a second investigation must be conducted, and a revised assessment regarding the appropriate amount of the duty must be made within 30 days of the commencement of the investigation. According to the Regulations, the final determination must be completed within 60 days of the start of the investigation. In fact, SECOFI's practice does not follow this schedule. SECOFI usually launches a formal investigation within three months of receiving a petition, and requires at least a week (although it could take as long as a month)

38. For example, in Canadian and U.S. AD and CVD actions, the agency is obliged to complete an administrative record (AR) of the evidence provided by counsel for the parties in a case. Decisions of the agency must be substantiated by the evidence in the AR. A reviewing court (or a binational panel) will scrutinize the same evidence used by the agency (i.e. the AR), and if it finds the agency's decision cannot be substantiated by evidence,the action can be remanded to the agency.

before a first provisional assessment is made.[39] The extension of deadlines is widespread throughout Mexico's unfair trade law administration. Consequently, although SECOFI is required to complete its investigation within six months, it usually takes between 15 and 18 months for completion once the proceedings are initiated, or 18 to 21 months from the filing date.[40]

A second problem with transparency in Mexico's trade administration relates to the compilation of the administrative record. There are no explicit provisions in the Regulations outlining what should constitute the administrative record. SECOFI can, therefore, effectively determine what should or should not be included in the written record. This use of discretion means that the record compiled is inadequate for the purposes of subsequent judicial review under a Chapter 19-like mechanism. A detailed record of the agency's actions is central to the appeal process. Without a proper record, a binational panel cannot effectively review the agency's practices and determine whether the challenged order was dealt with properly.

The absence of sufficient transparency in an agency's governing legislation and practice may adversely affect a party's interests. The uncertainty as to the time frame for SECOFI's investigations and duty assessments may impair the ability of parties to prepare properly for participation in the investigative and assessment process, as well as for payment of the duty. Moreover, parties may be unable to criticize an agency for unfair treatment where the agency appears to have acted within its broad discretionary powers. This problem is compounded by the fact that an absence of clear guidelines governing the compilation of the administrative record means that a superior body cannot fully know how an agency performed its duties. Therefore, it cannot assess properly whether the agency's actions met procedural standards intended to protect individuals from abuse of agency power.

Due Process

SECOFI's nonadherence to the deadlines envisioned by the Regulations raises another major concern about the extension of Chapter 19 in terms of the standard of due process in Mexico's unfair trade law administration. Due process requires that individuals whose interests are affected by an administrative action be given adequate notice of the action and sufficient opportunity to respond to it. Mexico's deadlines did not meet GATT standards of due process at the time it became a Contracting Party to the GATT, therefore Mexico extended them in practice. However, under binational review the deadlines as set down in the Regulations are applicable because they reflect the written law, even though they are contrary to GATT standards and are not adhered to by SECOFI.

In the United States, the analogous remedy to the imposition of a provisional duty under Mexico's Regulations requires the posting of a cash bond for every allegedly subsidized or dumped product, but it cannot be imposed until at least 90 days after the filing of an AD or CVD petition. Canada usually makes its dumping or subsidy determinations within 90 days, at which time it may impose provisional duties.

39. USITC, *Review of Trade and Investment Measures by Mexico,* USITC Report No. 2275 (April 1990), pp. 4-14.

40. Regarding time frame, it appears SECOFI's actual practice is more liberal than its written regulations. However, SECOFI's practice disadvantages exporters by creating legal uncertainty about deadlines; and, where procedures drag on extensively, by requiring exporters to pay duties while making a final determination.

Both these situations allow the affected industry to participate to some extent in the investigation and assessment of the provisional duty.

A clear example of a lower standard of due process in Mexico's system is reflected by the time frame established under the Regulations for SECOFI to conduct its investigations and duty assessments. SECOFI must initiate an investigation within five days of receiving a petition. Moreover, the Regulations contemplate the application of a first provisional duty within five days of the initiation of the investigation. Notice of both the initiation of the investigation and the first provisional duty assessment must be published in the *Diario Oficial*.[41] These deadlines conceivably permit the simultaneous publication of the initiation of the investigation and the imposition of a provisional duty. Under these legal requirements a potential respondent could be left unaware of both the preliminary investigation until it is published and the provisional duty until it is imposed. Consequently, an interested party could in law be required to pay a duty without forewarning or opportunity to participate in the assessment process. An additional point is that SECOFI bases its first provisional duty assessment on information from an international data bank, and not on data from the specific industry, and this prevents exporters from providing information in support of their individual circumstances.

The Mexican system currently provides a lower standard of due process than that in Canada and the United States with respect to who has the authority to appeal a final determination of SECOFI. According to the *Código Fiscal*, only importers of goods may appeal a finding of an unfair trade practice; exporters and domestic producers are prohibited from doing so. Thus, Canadian and U.S. exporters are currently unable to appeal decisions by SECOFI and would therefore be unable to request binational review under a Chapter 19 mechanism.

Structural Safeguards

Another element important to the common law notion of effective judicial review is the requirement that administrative agencies act independently or semi-independently of the government. In the case of AD and CVD determinations, this is necessary in order to depoliticize the process and ensure greater objectivity in the agencies' decisions. In addition, it is considered important that the injury determinations and dumping and subsidy assessments be made by two different agencies in order to prevent potential bias in the final decision.

The U.S. International Trade Commission (ITC) and the Canadian International Trade Tribunal (CITT) are independent bodies responsible for material injury determinations. Moreover, their determinations are made independently of the dumping or subsidy findings by the International Trade Administration (ITA) of the Department of Commerce (DOC) and the Assessment Programs Division of Revenue Canada (RC). The roles of the CITT, ITC, and ITA as regulatory agencies are both adjudicatory and investigative. Although the ITA is a branch of the DOC, it acts in a quasi-judicial manner and independently of the DOC. Revenue Canada's situation is somewhat different. It does not technically conform to the requirement of semi-independence since it is more closely connected with the federal revenue department, and this fact has been criticized by the United States. However, its determinations are reviewable according to the same standards as the injury findings of the CITT and are therefore at

41. The *Diario Oficial* is Mexico's equivalent to the *Canada Gazette* and the *Federal Register* in the United States.

least minimally acceptable. In spite of RC's unique situation, the semi-independence of the agencies responsible for dumping and subsidy determinations is still considered an important quality for effective judicial review.

As indicated above, dumping and subsidy determinations as well as injury findings are made in Mexico by SECOFI, effectively its Department of Commerce, and influenced by CACCE, an interagency working group consisting of officials from SECOFI and other executive agencies. The *Comisión de Aranceles y Controles al Comercio Exterior* advises SECOFI on the level of duty to be applied and the content of SECOFI's final resolution regarding the investigated merchandise.

SECOFI is neither independent nor semi-independent from the government. Moreover, dumping and subsidy determinations are not necessarily made independently of injury assessments. Given this fact, there is concern that SECOFI's findings may be either politically influenced or affected by its findings in the other category (i.e., a finding of dumping could be construed as providing evidence that there is injury).

Without transparency in the laws and proceedings, high standards of due process and the independence or semi-independence of the administrative bodies, judicial review is hollow and ineffective. SECOFI's broad discretionary powers which result from the lack of transparency in Mexico's unfair trade law administration create the potential for SECOFI's deadlines, as well as duty assessments, to be influenced by interested parties and government. Without the incorporation of higher standards in the way Mexico's trade law administration is conducted, a Chapter 19 dispute settlement mechanism in NAFTA would not be suitable.

Due process and the standard of judicial review aside, there are specific elements of Mexico's unfair trade law administration that are not as favorable to affected parties as the equivalent Canadian and U.S. provisions. The following will focus on some of these differences.

In Mexico, the proceedings culminating in a final determination are in practice considerably longer than in Canada and the United States. In the United States, a final determination must be made between 205 and 300 days after a countervailing duty petition is filed or between 280 and 420 days after the filing of an antidumping petition. In Canada, the CITT must make its final determination within 120 days after receiving notice of the preliminary determination from Revenue Canada. As indicated earlier, in Mexico, the complete process culminating in a final determination usually takes 18 to 21 months from the date the petition is filed. The length of the proceedings can have an impact on interested parties in Mexico in part because once a preliminary dumping or subsidy determination is made and a provisional duty is imposed, the affected importers must continue paying the duty until it is either finalized or revoked. This could be costly and detrimental to both importers and producers, especially where the preliminary finding is determined to be unsubstantiated in subsequent investigations.

Another difference among the parties' laws involves the timing of review of duty orders. Annual review of duty orders is required in the United States, while it is suggested for dumping values and subsidy amounts in Canada as well. The CITT may review its injury findings at its discretion. However, if a review is not initiated within five years of the original order, the order is automatically rescinded. In Mexico, such review is discretionary. It can be initiated by SECOFI at the request of an interested party or ex officio, where it appears justified in doing so. Once again, it is SECOFI's discretion that may unfavorably affect Canadian and U.S. exporters. Under Mexican law there is no consistency in SECOFI's initiation of review proceedings. Moreover, SECOFI is under no obligation to do so. Thus, there currently exists the potential that SECOFI's initiation or noninitiation of a review could be politically influenced.

To sum up the discussion, it is apparent that Mexico's AD and CVD system differs substantially from that of Canada and the United States. Yet the basis for negotiating a binational dispute settlement mechanism into the CUSFTA was the underlying compatibility of Canadian and American law and administrative practice. In seeking to negotiate a similar mechanism into the NAFTA, some basic accommodation on the part of Mexico was clearly required in order to maintain the standards of judicial review and due process inherent in the CUSFTA mechanism. This same choice will face other parties seeking to negotiate a WHFTA or to accede to NAFTA. The extent of Mexico's accommodation and the changes to Chapter 19 under the NAFTA is the subject of the concluding discussion.

Conclusion

There were similarities between Canada's and Mexico's approach to AD and CVDs in a regional trade agreement, and these may provide clues as to how this issue might play out in a WHFTA. First, both Canada and Mexico recognized that resort to unfair trade remedies by the larger trade partner—the United States—could threaten security of access to the U.S. market and thereby undercut the value of a trade agreement. Second, both Canada and Mexico sought an exception from U.S. unfair trade legislation, but failed. Third, Canada and Mexico tried to negotiate a broader understanding over the use of AD duties and CVDs, but these efforts also failed.[42] Finally, both countries settled on a binding dispute settlement mechanism built around an internationalized form of judicial review of domestic agency actions, as a surrogate for a more permanent solution to the problem of antidumping and countervail between close trading partners.

There were three important changes negotiated to Chapter 19 so that Mexico, Canada, and the United States could reach agreement in the NAFTA. First, the NAFTA includes a section (Article 1907:3) that outlines desirable qualities for the administration of antidumping and countervailing duty laws.[43] This change, as well as the two following changes, was added to NAFTA to ensure that Mexico's trade remedy system would be sufficiently similar to that of Canada and the United States to make a Chapter 19 mechanism suitable; and if not, to ensure that adequate remedial provisions are incorporated into the agreement to protect the other parties.

The rationale underlying these changes is that Chapter 19 presupposes that a binational panel will apply the domestic law of the party whose agency's determination is being challenged. As suggested earlier, where a party's administrative procedures, statutes, or standards of judicial review do not match, or at least come close to, those found in the other Parties' unfair trade remedy systems, interested nationals

42. In case of AD duties, such an understanding might be the use of national competition policy as an alternative to AD actions. For CVDs, an understanding might be a Subsidies Code negotiated on a North American basis, or the adoption of a Subsidies Code in the Uruguay Round.

43. For example, "publish notice of initiation of investigations"; "provide disclosure of relevant information ... [including] ... an explanation of the calculation or the methodology used to determine the margin of dumping or the amount of subsidy"; and so forth.

of those other Parties may not receive a standard of due process equivalent to that extended by their governments to foreign exporters.

Second, the NAFTA includes a section (Annex 1904.15(d) Schedule B) that outlines a series of 20 obligatory amendments to Mexico's unfair trade remedy regime similar to that of Canada and the United States. The proposed amendments are mainly procedural and are intended to address the low standards of due process that are characteristic of Mexico's unfair trade remedy legislation.[44]

For example, there are requirements that Mexican legislation provide explicit timetables for administrative proceedings, participation by interested parties, and timely access to all nonconfidential information. The Mexican law that allows for the imposition of duties only five days after receipt of a petition must be changed, and Mexico's recognition of parties having standing to request judicial review must be expanded to include foreign producers and exporters formerly excluded from seeking judicial review of an agency's determination. Perhaps most important, Mexico will be required to compile a comprehensive administrative record of the proceedings of the investigating agency and a detailed statement of legal reasoning underlying the agency determination, which is the basis for judicial review by a binational panel.

Third, under the title of "Safeguarding the Panel Review System," the NAFTA includes a section (Article 1905) that provides remedies if a Party does not comply with its obligations under Chapter 19. If the application of a party's domestic law prevents a binational panel from carrying out its functions, the NAFTA provides recourse to consultation and then to a special committee of three individuals selected from the same roster used for the purpose of establishing Extraordinary Challenge Committees.[45] If the committee finds a party has not complied with Chapter 19, the complaining party can suspend binational panel review or equivalent "appropriate" benefits with respect to that party. Article 1905 further provides that binational panel reviews between the disputing parties will be stayed, and will revert to domestic courts if necessary; and it gives the party complained against rights to retaliate in kind to a suspension of binational panel review by the complaining party.

In the event the party initially complained against removes the cause for complaint, provision is made to reconvene a special committee to assess the situation, and then to terminate countermeasures if appropriate. To sum up, given the successful history of Chapter 19 in the CUSFTA, it is unlikely a special committee would arise between Canada and the United States, but it may form a useful sanction to ensure that Mexico (or any other country acceding to the NAFTA) adopts the domestic practices necessary to implement Article 19. However, it is unlikely the extension of Chapter 19 to Mexico could survive any substantial use of Article 1905, since that article essentially signals a breakdown of the undertakings of Chapter 19 itself.

If other Western Hemisphere nations were to accede to NAFTA or negotiate a WHFTA, it is likely that a Chapter 19-like mechanism would appeal to them for the same reason it appealed to Canada or Mexico. A WHFTA negotiation would also raise some of the issues faced in the NAFTA negotiation, such as the role of amparo (which has been widely adopted in South America from the Mexican legal

44. It is probable that Mexico provides greater due process in practice than that required by Mexican law.

45. Extraordinary Challenge Committees were provided for in the FTA to permit an appeal from a binational panel decision on grounds, inter alia, of misconduct or abuse of power. The NAFTA has a similar provision.

system) and the Calvo doctrine in dispute settlement procedures, as well as the nature and procedural standards of AD and CVD investigations and assessments and their consequent impact on the standards of judicial review and due process under a Chapter 19-like mechanism.

The extension of Chapter 19-like procedures to a WHFTA would likely have some positive payoff for Canada and the United States. Canada would gain because the principle of binational review of unfair trade actions—which was originally a Canadian demand—would be more firmly established in North American trade policy. For the United States, the issue is more complicated. One would expect there would be domestic opposition to any perceived weakening of U.S. control over unfair trade remedies. On the other hand, a Chapter 19-like process might give an advantage the United States (and Canada) by curbing the expansion of AD and CVD use in its southern neighbors.

Mexico is now the third-largest user of AD actions worldwide, and any expansion of AD and CVD practices in South America could limit the potential for American exports in the future. Furthermore, there is no guarantee that other Western Hemisphere nations will conduct unfair trade remedy procedures in the manner American exporters might feel entitled to. Ironically, the less foreign practices conform to American notions of due process, the greater the incentive to negotiate a dispute settlement mechanism. If the United States is seriously interested in negotiating a WHFTA, it is likely to negotiate as well an internationalized legal regime to set limits on the national use of unfair trade remedies like AD and CVDs.

REGIONAL FREE TRADE AND THE ENVIRONMENT

Charles S. Pearson

Introduction

This paper analyzes issues at the intersection of two active areas in trade policy—revitalization of regional economic integration arrangements and efforts to harmonize trade and environmental policies.

Neither area is new. Economic integration attempts in the Western Hemisphere reach at least as far back as 1854 and the treaty between the United States and Great Britain that permitted duty-free trade in certain agricultural products between the U.S. and Canada. These attempts also include a reciprocity treaty between the United States and Cuba (1903) and a proposed customs union between the U.S. and Latin America (1890).[1] In more recent years the Latin American Free Trade Agreement, the Andean Common Market, and the Central American Common Market attempted to spur regional trade and development, without notable success in their initial years.

Analysis of the interaction between trade and environment flourished briefly in the 1970s and made substantial theoretical, empirical, and policy contributions.[2] The impetus for the research at that time was the surge of environmental regulations and concern for effects on competitiveness, and the 1972 United Nations Conference on the Human Environment (Stockholm Conference) which, for the first time, sensitizes analysts to possible interactions between trade and the environment. However, the issue lay dormant for most of the 1980s.

Interest in both policy areas has been reinvigorated in recent years. The United States-Canada Free Trade Agreement of 1987, EC-92, the efforts to complete integration in Europe and create a single market, and surprisingly rapid progress in negotiating a North American Free Trade Agreement (NAFTA) to include Mexico, all underscore the new vitality of regional economic integration. The trade-environment issue has re-emerged in a somewhat controversial manner, and much attention has bee paid to conflicts and potential conflicts between trade policies and environmental policies. While such conflict can be easily exaggerated, there are points at which trade and environmental regimes need to be reconciled.

Economic integration itself casts a brighter light on certain trade-environment questions: the international competitive effects of differences in environmental regulation and the desirability of harmonizing environmentally related product standards to create a unified market. Moreover, economic integration, like any effort at trade liberalization, will change the level and composition of production and

1. Latin America turned down the customs union on the sensible grounds that Europe, which provided Latin America with 90 percent of its imports, would not be pleased with overt tariff discrimination. See Benjamin H. Williams, *Economic Foreign Policy of the United States.* (New York: Howard Fertig, 1967).

2. See, for example, Charles Pearson and Wendy Takacs, "International Economic Implications of Environmental Control," Commission on International Trade and Investment Policy, *Papers,* Vol. 1 (Washington, D.C.: GPO, 1971); Ingo Walter (ed.), *Studies in International Environmental Economics* (New York: Wiley-Interscience, 1976); Organization for Economic Cooperation and Development, *The Polluter Pays Principle - Definition - Analysis - Implementation* (Paris: OECD, 1975).

consumption and hence affect demands on environmental resources. Finally, negotiating an economic integration agreement provides an opportunity to establish new environmental protection policies among the member countries.

The purpose of this paper is to sort through the issues at the intersection of trade and the environment, with special attention to particular questions arising from economic integration. The paper is divided into four sections. Section I provides an analytical framework by briefly reviewing relevant theory, setting forth a taxonomy of issues, and examining the issues within the context of economic integration. Section 2 considers the institutional and empirical dimensions of the trade-environment question, with an analysis of GATT rules and a brief review of quantitative research. Section 3 examines how trade and environmental objectives are reconciled (if indeed they are) in three integration agreements, the EC, the U.S.-Canada Free Trade Agreement, and the NAFTA. The final section puts forward some thoughts on how trade and environmental objectives might be reconciled in a broader Western Hemisphere free trade agreement.

This study is only an introduction to the issues. The interaction of trade and the environment is complex, and the questions it raises deserve detailed research as the process of economic integration in the Western Hemisphere proceeds.

I. Analytical Framework

Trade and environment issues are diverse. An organizing framework is necessary to apply relevant theory and analyze policy. At the risk of oversimplification, most issues can be grouped into four categories:

(a) the trade effects of environmental regulation of production (the competitiveness issue),
(b) the trade effects of environmentally related product regulations,
(c) the use of trade measures to secure international environmental objectives, and
(d) the environmental effects of trade and trade liberalization.

International environmental externalities (transboundary pollution) are not themselves a separate category. Nonetheless, if they are present they may modify the analysis significantly. In similar fashion, regional economic integration is not itself a separate category, but when folded into these four categories may change the analysis. This paper examines these four sets of issues in the context of regional economic integration. A review of relevant conclusions from theory will be useful.

Theoretical Considerations

Four strands of economic theory contribute to this paper's analysis of trade-environment issues. First, the traditional factor endowment theory of trade has been extended to include environmental resources.[3] The basic approach is to recognize that countries differ in their supply of and demand for environmental resources, and hence the implicit price of their services. This arises from differences in physical assimilative capacity (the ability of the environment to absorb wastes and render them harmless), economic structures, income levels, and preferences. Furthermore, goods differ in their relative use of environmental services, either as direct production inputs (soil structure and quality, industrial process water) or in their waste profiles. It follows that differences among countries in relative environmental endowments and demands for environmental services, together with conventional factor endowments (labor and capital), contribute to comparative advantage and thus are sources of gains from trade. Moreover, it follows that as countries move to incorporate environmental costs in product prices through direct regulation, pollution taxes, or other measures, prior trade distortions arising from unpriced environmental resources will be reduced. Changes in the pattern of international trade are to be expected and welcomed. In short, trade can contribute to the efficient use of environmental resources, provided that product prices reflect the full social cost of production, including environmental protection and resource depletion costs. Conversely, an attempt to equalize environmental costs internationally in the face of differences in environmental endowments and demand for environmental services would be inefficient and would reduce gains from trade. It would also lead to misallocation and misuse of environmental resources.

Three caveats are in order. First, environmental services are seldom priced in competitive markets, and their social price and the resulting pattern of comparative advantage are subject to unusual uncertainty. Second, partial inclusion of environmental costs in product price by one country but not by another may or may not improve resource allocation and welfare globally. Efficiency in trade is again difficult to determine. Third, environmental externalities can have international effects. Hence fixing the price of environmental resources through a national calculus of benefits and costs may be suboptimal from a global perspective.

The second helpful strand is the theory of domestic distortions and the related theory of the second best. The principal conclusion from that theory is that policy should be directed to correcting market distortions at their source. Environmental externalities—distortions—arise in production and consumption, not in trade per se. This implies that trade measures are not first-best instruments for achieving environmental objectives. Trade measures may or may not improve welfare.

The third theoretical strand comes from the growing literature on managing transboundary pollution and global environmental problems. That literature suggests that for effective international agreement to reduce international pollution, some system of payments or sanctions may be necessary to control free riders and secure widespread compliance.[4] Because mechanisms for direct payments are underdeveloped and because the range of noneconomic sanctions is limited, there is pressure to use trade measures—either inducements or coercion—to secure environmental objectives.

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3. Horst Siebert, "Environmental Protection and International Specialization," *Weltwirtschaftliches Archiv,* 1974; R. Pethig "Pollution, Welfare, and Environmental Policy in the Theory of Comparative Advantage," *Journal of Environmental Economics and Management,* 1976.

4. For a general discussion see Scott Barrett, "The Problem of Global Environmental Protection," *Oxford Review of Economic Policy,* Vol. 6, No. 1, Spring 1990.

Finally, political economy theory suggests that under certain assumptions, environmental interest groups may reinforce protectionist interests and increase the probability of inappropriate or inefficient use of restrictive trade measures for environmental purposes.[5]

Trade Effects of Environmental Regulations of Production

The main trade issue is competitiveness. Environmental regulation of production through effluent and emission standards, input or technology requirements, zoning, or pollution taxes all increase production costs. The trade effects are reviewed in Section II, below. In general, sectors with high environmental control costs relative to other industries and relative for foreign suppliers, will lose international competitive position. If exchange rates move to adjust the trade balance, sectors with low environmental control cost should gain in their international competitive positions.

In general these shifts in costs and trade will improve global efficiency in the use of environmental resources. However, there are certain legitimate areas of concern. A large, rapid change in competitive positions may involve short-run adjustment costs at the industry or firm level, and some form of transitional adjustment assistance may be economically efficient. Moreover, if foreign competitors fail to establish environmental standards appropriate to their assimilative capacity, income, etc., an implicit environmental "subsidy" is present, and trade remains distorted. This raises the question of whether a border adjustment scheme—tariffs and export rebates—to narrow environmental cost differences is desirable. For a small country with no market power or ability to influence foreign environmental performance, border measures would be welfare reducing. A rebate of environmental control costs at the border would maintain the wedge between private and social production costs, maintain excessive production of the polluting product, and "subsidize" exports. An offsetting tariff on imports would maintain excessive production of the import competing product and increase domestic prices. The large country case is more complicated. If border measures were successful in raising foreign environmental standards to their social optimum, the trade and resource allocation distortion would disappear, the border measures would become redundant, but the home country would have denied itself the opportunity to import "subsidized" products. If unsuccessful, the welfare-reducing effects re-emerge.

Two serious practical problems with border adjustment are the difficulty in accurately determining the socially optimal levels of environmental protection in other countries, and the possible capture of such a scheme by protectionist interests. The broader question is whether the trade system is robust enough to be used as a tool for securing international environmental objectives. There is, of course, no case for offsetting legitimate differences in environmental control costs, the existence of which are sources of gains from trade.

Another area of concern is the financing of environmental control costs. Even if all environmental standards are optimal, if one country's government subsidizes and a second requires the private sector to pick up the cost, trade remains distorted. The OECD response to this problem was the adoption of the Polluter Pays Principle (1972), under which governments undertake to avoid subsidies for environmental control costs incurred in the private sector. The PPP contributes to efficiency in trade

5. Craig Vance Grasstek, "The Political Economy of Trade and the Environment," in Patrick Low (ed.), *International Trade and the Environment* (Washington, D.C.: World Bank Discussion Paper No. 159, 1992).

and in environmental resource use. The PPP does permit some transitional assistance to industry. The GATT subsidy provisions are discussed more fully in Section II, below.

The environmental perspective adds two new elements to the competitiveness issue. First, environmentalists may object to shifting highly polluting industries abroad even if no transnational pollution is involved. This reflects the generally stronger global welfare perspective of the environmental community. But such a perspective introduces the "eco-imperialism" problem, in which one country attempts to internationalize its preferences, without directly bearing the cost of environmental protection.

Second, environmentalists may believe that a concern for competitive loss inhibits strong domestic environmental regulations, and thus they may favor measures such as border adjustments to relieve domestic producers of some international competitive pressure. This consideration underlies the potential coincidence of interests between environmental and protectionist groups.

Regional economic integration increases the saliency of the competitiveness issue. As border barriers are dismantled, domestic regulations, including environmental regulations but also competition policy, minimum wage legislation and a host of other government interventions that affect production costs, become more important. Because regional integration now extends to freeing up capital flows and direct investment, the extent of environmentally motivated relocation of production may also increase. The empirical evidence is reviewed below.

The negotiation of a regional economic integration agreement provides the opportunity for harmonization of environmental regulation on production. Some theoretical work suggests that certain regulatory structures (e.g., environmental norms, tax structures) need not be harmonized *ex ante* in regional integration, but will emerge *ex post* through institutional competition (countries compete through their policy instruments).[6] It is further argued that locational arbitrage need not result in a lower level of environmental quality, but should lead to long-run harmonization of environmental policies. All this supposes that national political processes reveal national preferences, and that transboundary pollution is absent. The argument was developed in the context of European integration, and whether it is appropriate to Western Hemisphere integration is an open question.

Trade Effects of Environmentally Related Product Standards

Product standards—for example, auto emission requirements and pesticide residue standards—should be distinguished from production regulations. The former protect the health, safety, and environment in the consuming country, while the latter protect the producing country.[7] The distinction, however, is not so clear when transboundary pollution is present. Environmentally related

6. Horst Siebert, "The Harmonization Issue in Europe: Prior Agreement or a Competitive Process?" in Horst Siebert (ed.), *The Completion of the Internal Market* (Tubingen: J. C. B. Mohr, 1990).

7. The specialized literature distinguishes between *technical standards*, which are voluntary and drawn up by private bodies, such as the International Standards Organization (ISO) and *technical regulations*, which are established by public law. We follow the common practice of using the term product standards to indicate technical regulations. United National Industrial Development Organization, *International Product Standards: Trends and Issues* (Vienna: UNIDO, PPD182, January 1991).

product regulations are a subset of product regulations generally and pose no new theoretical issues (apart from the possibility of transboundary pollution). Their number and scope has grown rapidly, however, and they are proving to be highly contentious.

Product regulations pose two trade problems. First, regulations drawn up by importing (consuming) countries ostensibly may be intended to protect health, safety and the environment but may in fact be covert trade barriers designed for protectionist purposes. Separating legitimate measures from covert protection is difficult, as the intent as well as the effect must be considered. (GATT treatment of product standards is discussed in Section II.) Second, even absent covert protection, international differences in product standards fragment markets and increase design, production, inventory and selling costs.

Harmonizing environmentally related product standards internationally would reduce covert protection from arbitrary national standards and increase efficiency in trade. Harmonization, however, presents environmental problems. Appropriate standards may well differ from country to country, because of differences in assimilative capacity, income levels, and willingness to tolerate environmental risk. If standards were harmonized at a "low" level, some countries would confront standards below their optimal level (the least common denominator problem); if harmonized at a "high" level, other countries would confront standards more costly than their circumstances warrant.

Once again regional economic integration does not alter the essence of the issue but increases saliency. Regional free trade is incomplete without the uniformity of product regulations if a single market. But uniform standards may be inappropriate for countries with different economic and environmental conditions. As discussed below, this has been a particularly difficult problem in the EC and again in the NAFTA negotiations.

Trade Measures to Secure International Environmental Objectives

This issue overlaps with competitiveness, as border adjustment to equalize environmental control costs may be supported for either trade and competitiveness reasons, or to influence foreign environmental behavior, or both. It also overlaps with the product standard issue, if product restrictions are drawn up to include regulation of the manner in which products are produced.

For analytical purposes it may be useful to separate two situations: unilateral use of trade measures (sanctions, inducements) to change foreign environmental policy; and trade provisions incorporated into international environmental agreements. With respect to the first, (1) only countries with some market power (terms of trade or market access) can resort to these measures, (2) trade sanctions will be efficient only if they lead to correction of the foreign environmental externality at its source, and (3) the use of trade measures for international environmental purposes is currently subject to certain GATT disciplines.

To elaborate, it is clear that trade carrots and sticks are available only to relatively large countries. But this points to an asymmetry between coercive and inducement measures: the coercing country is under no requirement that the benefits from foreign environmental protection exceed the costs—it is simply an exercise of international market power—whereas a country offering a trade inducement, say, lowering a tariff in exchange for a commitment to improve foreign environmental protection, bears a "cost" and will presumably consider the benefit in relation to that cost.[8] Trade liberalizing inducements, of course, have the additional advantage of reducing rather than raising trade barriers. A trade sanction that fails to change foreign environmental behavior simply reduces home and world welfare. Moreover, certain types of trade measures—for example, a countervailing duty against an implicit foreign environmental subsidy that results in a foreign export tax—might or might not improve environmental protection.[9] The trade sanction may have corrected the trade distortion (subsidized exports) but, by failing to deal at the source, may increase environmental abuse.

Trade provisions in international environmental agreements are increasingly common.[10] One purpose, mentioned above, is to discipline free riders and broaden participation. How often this is necessary, however, is an open question. In-principle agreements that are structured so that all members are made better off, using side payments if necessary, should attract the requisite number of countries. If sufficient payments cannot be made, the welfare improvement of the agreement is called into question.[11] Moreover, free riders will come into existence only if an agreement is reached. If countries are aware that their failure to participate would scrap a potential agreement, their choice is between the cost to them of no agreement and the net cost (including side payments) of joining. By introducing an additional trade sanction cost, they become "forced riders," and the asymmetry between coercive and inducement schemes is again relevant.

A second function of trade provisions in international environmental agreements is to improve the effectiveness of the agreement. For example, trade and production controls may substitute for direct consumption controls. The numerous conventions dealing with international traffic in wildlife appear to fall into this category, as does the Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and Their Disposal. The principal issue here is to be assured that trade controls are the most efficient/least costly measures available.

The use of trade measures for international environmental objectives is relevant to regional economic integration. The negotiations leading to integration provide an opportunity to change foreign environmental practices. The prospective benefits from integration provide a potential vehicle for compensation. How these may be used is considered in Sections III and IV.

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8. This is a very mercantilist view, in which lowering a tariff is viewed as a concession, or cost.

9. The export tax may encourage inefficient local processing and resource waste. Indonesia's export tax and subsequent export ban on logs and the consequent increase in local processing is said to have wasted up to 10 percent of wood volume as compared to international input/output performance in wood processing. Donald Hanna, *Fiscal Policies and Environmental Outcomes: Some Examples from Indonesia* (Washington, D.C.: The World Bank, 1991), as cited by Carlos Alberto Primo Braga, "Tropical Forests and Trade Policy: The Case of Indonesia and Brazil," in Low (ed.), *International Trade...*, op. cit.

10. Of 127 multilateral environmental agreements between 1933 and 1990, 17 contain trade provisions. U.S. Congress, Office of Technology Assessment, *Trade and Environment: Conflicts and Opportunities* (Washington, D.C.: U.S. GPO, May 1992).

11. At a high level of abstraction, the benefit to some parties must be sufficient to compensate those who lose for a Pareto improvement.

The Environmental Implications of Trade Liberalization

Concern for the environmental effects of trade liberalization is very recent. Some theoretical work is now being published, but it is by no means comprehensive.[12] Perhaps the most basic question is whether trade liberalization harms or improves the environment. The answer depends upon what environmental policies, if any, are in place. If environmental protection is absent, then it is easy enough to show that when trade leads to specialization and production of pollution intensive goods, the home environment suffers, whereas specialization in "clean" industries reduces environmental stress, at least at the national level. More generally, trade liberalization reduces some distortions but, as the theory of the second best reminds us, welfare losses from uncorrected environmental distortions may outweigh trade efficiency gains.

The agricultural sector is often used for illustration.[13] Production, consumption and trade start from highly distorted patterns. In general, rich countries subsidize and protect agriculture; poor countries tax and provide negative effective rates of protection. Modelling trade liberalization first requires estimating the effects on price, production, and consumption levels and patterns, and then the further step of tracing these changes back to intermediate input use (e.g., fertilizer) and demand for primary inputs (soils, water), to build a profile of environmental demands. Specifically, there is concern that agricultural expansion in developing countries will increase the use of chemicals and intensify deforestation if protective policies are not in place.[14] Much depends on property rights and land tenure arrangements, as well as controls on offsite externalities.[15]

Theoretical analysis of the environmental consequences of liberalization confronts further complications. Trade liberalization may itself encourage better environmental policy. In addition, it is frequently argued that the income gains from trade contribute to higher environmental standards and enforcement.[16] Three points seem clear. First, trade liberalization itself does not cause environmental deterioration. Second, trade liberalization may increase the need for environmental protection measures.

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12. Kym Anderson and Richard Blackhurst (eds.), *Greening World Trade Issues* (Ann Arbor: University of Michigan Press, 1992); Ramon Lopez, "The Environment as a Factor of Production: The Economic Growth and Trade Policy Linkages," in Low (ed.), *International Trade ...,* op. cit.

13. Kym Anderson, "Effects on the Environment and Welfare of Liberalizing World Trade: The Cases of Coal and Food," in Anderson and Blackhurst (eds.), *Greening...,* op. cit; C. Ford Runge, "Environmental Effects of Trade in the Agricultural Sector" (St. Paul: U. of Minnesota Center for International Food and Agricultural Policy, July 1992).

14. Anderson, however, argues that as trade liberalization tends to equalize agricultural prices worldwide, the reduction in agricultural chemical use in developed countries would not be matched by increased use in developing countries, as the developing country agriculture will be (relatively) labor using and chemical sparing. Anderson, "Effects...", op. cit.

15. Gershon Feder et al., *Land Policies and Farm Productivity in Thailand* (Baltimore: Johns Hopkins Press, for The World Bank, 1988).

16. Robert Lucas, David Wheeler and Hemamala Hettige, "Economic Development, Environmental Regulation and the International Migration of Toxic Industrial Pollution" in Low (ed.), *International Trade...,* op. cit.

Finally, for resource management purposes, it is highly desirable to improve models that link trade liberalization to environmental resources.[17]

These conclusions are relevant for both global (i.e., MFN) and regional trade liberalization. There are, however, two differences worth noting. First, regional integration arrangements—free trade areas or customs unions—are preferential and hence discriminatory. Consequently a trade distortion always remains, and the interaction of that distortion with any uncorrected environmental externalities requires special analysis. One example might be if NAFTA increases trade diversion in sugar, and this leads to greater environmental stress in nonmember Caribbean countries. Second, regional integration among contiguous countries or littoral states sharing a common water resource may intensify transboundary effects. This has been a central issue in NAFTA.

II. Institutional and Empirical Aspects

GATT provisions bearing on trade and environment are relevant to regional economic integration. Most important, GATT regulates trade measures in the product standards and competitiveness areas, both of which are central to the integration-environment debate. Moreover, regulations incorporated in regional agreements may parallel GATT provisions as, for example, EC law regarding product standards.[18] Finally, regional economic integration arrangements must be GATT-consistent for GATT members.

Quantitative estimates of the trade and investment effects of environmental regulations, and of the environmental effects of trade liberalization, are also important in determining whether purported issues—for example, industrial relocation—will be significant or trivial in Western Hemisphere economic integration. This section examines GATT provisions and then summarizes quantitative research.

The GATT on Environmental Issues

Product Standards. GATT does not require harmonization of product standards. In general, as long as the tests of nondiscrimination and national treatment are met, and the prohibition (with exceptions) against the use of nontariff trade measures is respected, members can establish whatever product standards they wish to secure national objectives for health, safety, and environmental protection. Moreover, the "general exceptions" provision (Article XX) allows countries to take measures that would otherwise violate GATT, if these measures are not applied "in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade." Article XX explicitly includes measures "(b) necessary to protect human health, animal or plant life or health; ...(g) relating to the conservation of exhaustible

17. Actually, concentration on trade liberalization is too narrow an approach. The environmental effects of all relevant trade and production effects should be modelled. It makes little difference if the production externalities arise from exports or goods sold domestically. For a start see the contributions in John Sutton (ed.), *Agricultural Trade and Natural Resources,* (Boulder, Colorado: Lynne Rienner, 1988).

18. Article 36 of the EC Treaty parallels GATT Article XX, the exceptions clause.

natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption."

GATT panels have considered five cases in which countries have used Article XX for justification of environmental measures.[19] In two cases the panels found the trade restraints to be unrelated to resource conservation.[20] In the Thailand-U.S. cigarette case the panel found Thai import restrictions to be not "necessary" in that less restrictive trade measures were available to protect health in Thailand. In the U.S. Superfund case, the panel found that a disputed U.S. tax on chemical products for clean-up purposes was a tax on products and hence eligible for border adjustments (i.e., the tax could be levied on imports) as is normally the case, and that the environmental purpose of the tax was not relevant. In the U.S.-Mexico tuna-dolphin case, the panel found that the U.S. restriction on imported tuna was not justified because, among other reasons, Article XX applied only to the protection of health or life or natural resources within the jurisdiction of the importing country.[21] These cases indicate that the GATT has been attempting to refine its rules on product standards, but certainly not always to the satisfaction of environmentalists.

The GATT Standards Code is also relevant.[22] The Code reaffirms the principles of national treatment and MFN, encourages but does not require international standards, encourages the more efficient performance over design standards, provides for notification and foreign comment in setting regulations, and establishes a dispute-settlement procedure. Some 378 environmentally related notifications were made between 1980 and 1990, but no cases have been brought into and resolved under the Code's dispute-settlement procedures.[23] This suggests that either trade disputes from environmentally related product regulations have been minimal or there is no confidence in the dispute-settlement mechanism.

Two changes in the Uruguay Round are worth noting. First, a separate agreement covering sanitary and phytosanitary measures is to be hived off and the scientific basis for product regulation is emphasized. Second, in some versions of the proposed Uruguay Round agreement, provisions regarding standards would be extended to cover regulation of process and production methods. Both changes have potentially far-reaching effects. There is an active debate whether it is desirable or feasible to look to "sound science" as the prime authority on environmental regulations of products, and whether GATT (or the proposed WTO) is the place to do so. Also, if countries are permitted to limit import of products

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19. For a review see OTA, *Trade and Environment...*, op. cit.

20. In one case the U.S. had banned tuna imports from Canada following Canadian seizure of U.S. tuna boats in Canadian waters. In the second case Canada restricted the export of certain unprocessed herring and salmon, and the GATT panel found this was not done for conservation purposes. See p. 53, below.

21. OTA, *Trade and Environment...*, op. cit.

22. GATT Agreement on Technical Barriers to Trade, 1979.

23. The U.S. attempted to bring the U.S.-EC beef hormone dispute to the Code's dispute settlement procedures but was blocked by the EC. The U.S. subsequently acted unilaterally through Section 301 of the 1974 Trade Act, following which a U.S.-EC Beef Hormone Task Force was established. OTA, *Trade and Environment...*, op. cit.

based on those products' process and production methods, the unilateral extension of environmental norms internationally would appear to be far easier.[24]

To summarize, there are four unresolved questions in GATT's rules on environmentally related product standards.

1. Should countries be permitted to control imports, not only on the basis of the product's characteristics but also as the basis of the product's process and production methods?

2. Should countries be permitted to control imports in order to protect international environmental resources or the environment of other countries?

3. To what extent must environmental regulations of products be based on scientific criteria and evidence, and how is that to be accomplished?

4. How should the ambiguous terms in Article XX—for example, "arbitrary or unjustifiable," "disguised restriction," and "necessary to"—be interpreted?

Production Regulations (the competitiveness issue). GATT does not directly concern itself with changes in international competitive position resulting from environmental regulations or indeed most other causes. On the contrary, GATT provides a set of rules that permit production-cost changes to be reflected in new trade patterns and flows. Nevertheless, GATT does regulate subsidies and those provisions are relevant to the issue at hand.

GATT prohibits export subsidies for nonprimary products, permits export subsidies for primary products but not in a manner that allows an exporting country to capture more than an "equitable" share of world trade, and permits domestic subsidies, but not if such subsidies increase exports or reduce imports and seriously prejudice the interests of other countries. The GATT Subsidies Code lists export subsidies, elaborates on "equitable share," and lists domestic subsidies for which there is no intention of restricting use (including R & D subsidies and subsidies for industrial redeployment to avoid congestion and environmental problems).

If GATT-inconsistent subsidies are found to be present, countervailing duties are permitted. But their imposition requires that the foreign subsidy causes or threatens material injury to a domestic industry, and the duty is limited to the amount of the foreign subsidy. The material injury relates to commercial injury in the importing country, not environmental damage in the exporting country. The purpose of subsidy-countervailing duty provisions in GATT is twofold: to limit or prevent subsidies from creating trade distortions, an efficiency objective; and to maintain a perception that the trade system is "fair," necessary to maintain political support for liberal trade.

24. Note the GATT does permit import limits if the imports are produced with prison labor. For excellent historical analysis of Article XX, and the congruence of ecological and labor issues in trade rules, see Steve Charnovitz, "Exploring the Environmental Exceptions in GATT Article XX" (*Journal of World Trade,* Vol. 25, No. 5, October 1991), and Charnovitz, "Environmental and Labor Standards in Trade" (*The World Economy,* Vol. 15, No.3, May 1992).

There are three types of "environmental subsidies." First, governments may provide financial support, including tax relief, to the private sector for pollution abatement and environmental protection. This assistance is not permitted, except in transitional circumstances, under the Polluter Pays Principle adopted by the OECD in 1972. Financial subsidies may also conflict with GATT rules, especially if related to exports. Financial subsidies may be countervailable, depending on the form they take.

From a purely environmental standpoint, subsidies for pollution abatement have mixed results. On the one hand, they maintain the divergence between market prices and social costs and perpetuate a misallocation of environmental resources. On the other hand, environmentalists argue that by weakening industry opposition, the availability of subsidies permits governments to move more rapidly toward strong environmental regulation. Except for the U.S., Canada, and Mexico, Western Hemisphere countries are not members of the OECD and are not bound by the Polluter Pays Principle. Whether to insist on the PPP in regional integration is thus a key issue. Another issue that may emerge is whether international financial assistance for pollution cleanup might be countervailable. The most likely example would be Western aid to Eastern European firms, but if U.S. funds are made available to Mexico in NAFTA, a potential GATT conflict emerges.

Second, governments may offer subsidies for environmentally sound activities, as, for example, taking fragile soils out of production or subsidizing consumption of clean fuels. In principle such subsidies are distortion-correcting and to countervail them would be undesirable. However, if the subsidy is granted for the use of a product, it should be available for the imported as well as domestically produced products to avoid a trade distortion.

Third, and perhaps most difficult, are "implicit environmental subsidies" in which a country chooses artificially low environmental standards, or fails to enforce standards, with a view to improving its trade position or attracting foreign investment. The existence of such a "pollution haven" strategy is difficult to determine because, as argued earlier, appropriate standards are country-specific. Allegations of implicit environmental subsidies are not restricted to developing countries; U.S. water and public land-grazing policies that lower environmental input costs have also been cited.

Given current GATT subsidy rules, it is unlikely that implicit environmental subsidies, if they exist, would be countervailable.[25] Nevertheless, this remains a hot issue and legislation to offset environmental control cost differences at the border has been introduced in the United States Congress. Whether and how implicit environmental subsidies are to be taken up in regional economic integration is another important unresolved issue.

GATT and International Environmental Agreements. Several international environmental agreements contain trade provisions. Among the best known are the Montreal Protocol, which restricts trade in CFCs and potentially restricts trade in products whose production uses CFCs, and the Endangered Species Act.[26] It is now clear that some trade provisions in environmental agreements may conflict with GATT in the future. Except for the possibility that regional economic integration might be accompanied by regional environmental agreements with trade provisions, the compatibility of GATT and

25. The environmental subsidy question is not new. See Charles Pearson, "Environmental Control Costs and Border Adjustments" (*National Tax Journal* XXVII, No. 4, December 1974).

26. GATT has taken up this issue in its revitalized Trade and Environment Working Group.

international environmental agreements is not directly relevant to economic integration in the Western Hemisphere. However, the compatibility of environmental agreements with *regional trade agreements* is an issue and was addressed in NAFTA (see Section III below).

Empirical Research

Quantitative work on trade-environment issues falls into two groups: the effects of environmental regulations on trade and investment flows, which bears on the competitiveness issue; and estimates of the environmental effects of trade and trade liberalization. Research on the latter question is both very recent and very limited, and there are no systematic studies of environmentally related product standards and their effect on trade.[27] Although most of the studies reviewed below did not explicitly consider regional economic integration, their results are nevertheless of interest.

Trade and Investment Effects of Environment Policies. Judith Dean has provided a good review of empirical work through 1990.[28] On the basis of studies reviewed, she concludes that there is little evidence of any significant impact of environmental control costs on the pattern of trade. She reaches a similar conclusion with respect to investment and industrial relocation.[29] One reason for the small trade effect appears to be that pollution abatement costs tend to be a small component of total production costs, and that international *differences* in abatements have narrowed as all OECD countries have established relatively strong environmental regulations and have adopted the PPP.[30] The minimal impact on aggregate investment flows through multinational corporations (MNCs) might be explained by the relative unimportance of pollution abatement regulations as compared to other locational determinants—cost and quality of labor, access to raw materials, market size, and hospitable business climate. MNC investments in developing countries may also build in pollution abatement to take advantage of off-the-shelf, clean technology in anticipation of a future tightening of environmental regulations or to avoid controversy and maintain good relations with host countries.

On their faces, these are reassuring conclusions. If the trade and investment effects are minimal, the competitiveness issue diminishes and there is less reason to delay strong environmental legislation in either home or host countries. Nevertheless, the studies through 1990 are not conclusive. One

27. For an early effort see Charles Pearson, *Environmental Policies and Their Trade Implications for Developing Countries, with Special Reference to Fish and Shell Fish, Fruit and Vegetables* (New York, UNCTAD/ST/MD/26, 1982). More recently see Keith Kozloff and C. Ford Runge, "International Trade in the Food Sector and Environmental Quality, Health and Safety: A Survey of Policy Issues" (mimeo, University of Minnesota, May 1, 1991).

28. Judith Dean, "Trade and the Environment: A Survey of the Literature," in Low (ed.), *International Trade...,* op. cit.

29. In a series of interesting country studies Leonard concluded that several countries (Ireland, Spain, Mexico and Romania) may have followed a "pollution haven" strategy in the 1970s but have since changed their approach. H. Jeffery Leonard, *Pollution and the Struggle for World Product* (New York: Cambridge University Press, 1988).

30. OECD, *Pollution Control and Abatement Expenditures in OECD Countries* (Paris: OECD Environmental Monographs No. 38, November 1990).

shortcoming is that all focused on industrial pollution control costs and did not consider environmentally motivated regulations on natural resource sectors. Moreover, methodological and data constraints did not allow most of the studies to pick up more micro impacts, including the environmental dimension of Mexico's *maquiladora* industries.[31] Third, recent and prospective environmental regulations may involve greater costs and change the picture. Controls of greenhouse-gas emissions are a case in point. Finally, the creation of regional free trade and regional free investment may create conditions under which previously suppressed competitive effects reveal themselves. For all these reasons, the competitiveness issue has not been laid to rest.

Several new studies (post-1990) cast new light on the trade and investment effects of environmental regulations. Grossman and Krueger use cross-sectional data to estimate the effect of per capita income on three types of air pollution. They find that two pollutants, sulphur dioxide and dark matter, follow an inverted "U" path, increasing up to per capita GNP levels of $4,000-5,000 and diminishing at higher levels.[32] They speculate that this might be the result of income-elastic demand for a cleaner environment resulting in stronger pollution regulations and enforcement. If so, it implies that cost differences and trade effects should narrow at higher income levels.

Grossman and Krueger also examine the composition of maquiladora activity in Mexico, and the composition of U.S. imports from Mexico. Using econometric techniques, they find the traditional determinants of trade—factor intensities and U.S. tariff rates—are significant in determining sectoral composition of imports, but pollution-abatement costs by sector are not. This finding suggests that the pollution haven effect has been absent or minimal.

Some indirect evidence of the effects of differential environmental control costs in U.S.-Mexico trade is also available in research by Patrick Low.[33] His study simulated the effects of simultaneously creating free trade between the U.S. and Mexico and adding back in an import duty equivalent to U.S. expenditure on pollution abatement in "dirty industries" (pollution control expenditures in excess of 0.5 percent of costs). Two findings are of interest. First, pollution-intensive products accounted for only 11 percent of Mexico's exports to the U.S. (1989), but grew at an average rate of 9 percent during the 1980s; second, the imposition of a pollution abatement equalization tax would amount to only a two-percent export loss to Mexico. The implication of the latter finding is that because equalizing cost differences would have little trade effect, current cost differentials have minimal impact on trade flows.

Lucas, Wheeler, and Hillige[34] use EPA's Toxic Release Inventory data and UN sectoral output data to test several hypotheses bearing on the trade and investment effects of environmental regulation. They find support for the hypothesis that the pollution intensity of manufacturing (measured by manufacturing emissions per unit GNP) has an inverted U relation to per capita income, a finding

31. But see the studies by Patrick Low and by Gene Grossman and Alan Krueger, reviewed below.

32. Gene Grossman and Alan Krueger, "Environmental Impacts of a North American Free Trade Agreement" (Cambridge, Massachusetts: NBER Working Paper 3914, November 1991).

33. Patrick Low, "Trade Measures and Environmental Quality: the Implications for Mexico's Exports," in Low (ed.), *International Trade...*, op. cit.

34. Lucas et al., "Economic Development...," op. cit.

consistent with Grossman and Krueger. (Recall that Grossman and Krueger used ambient air quality and not emission and effluent data.) They further find some support for the hypothesis that stricter regulation of pollution-intensive production in the OECD has led to locational displacement, but they acknowledge that this may be an artifact of restrictive trade policies in the developing countries rather than cost differences.

Patrick Low and Alexander Yeats use data on environmental control costs by industry and trade data disaggregated by country and sector to investigate whether "dirty" industries migrate.[35] They find that (a) the share of "dirty products" in world trade declined from 19 percent to 16 percent between 1965 and 1988, and (b) the share of industrial countries in dirty industry trade declined from 78% to 74% in the same period, while the share of nonindustrial countries in dirty goods trade increased from 22 percent of 26 percent. This latter finding is consistent with the hypothesis that environmental control cost differences affect trade patterns, but is not conclusive. Nor does it necessarily justify policy intervention for cost harmonization.

Next, a new *ex ante* study by Piggott, Whalley, and Wigle investigates the possible effect on world trade of a multilateral reduction by 50% of carbon emissions over the 40-year period, 1990-2030.[36] Using a six-region computable general equilibrium (CGE) model that excludes international capital flows or trading in carbon emission permits, and assuming consumption rather than production restrictions, they estimate very large reductions in the volume of world trade (up to 83% for oil exporters and 53% for aggregate global trade among the regions). While different modeling assumptions might yield smaller trade losses, the study does underscore the possibility that *new* environmental initiatives may have much more profound trade consequences than have been felt in the past. The study also underscores the differences between consumption- and production-based restriction on welfare distribution, a point that has been made elsewhere in the literature and bears directly on the issue of side payments to encourage compliance.

Finally, even if it is difficult to show that there has been large-scale relocation of production and trade *because* of intercountry differences in environmental policy, it is not at all difficult to demonstrate environmental deterioration that is proximately linked to foreign direct investment and production for export.[37] The U.S.-Mexican border region is perhaps the best example. By 1991, 1,440 maquiladora operations employed 340,000 workers and generated $3.5 billion in foreign exchange. The result of this activity, together with chemical- and water-intensive agriculture, has been serious air, water, and soil pollution, and severe public health problems.

To summarize, the literature through 1990 pointed toward minimal aggregate trade and investment consequences of differences in environmental regulation. The more recent *ex post* studies show that some effect on trade and industrial relocation cannot be ruled out. More micro work on U.S.-Mexican trade

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35. Patrick Low and Alexander Yeats, "Do Dirty Industries Migrate," in Low (ed.), *International Trade...*, op. cit.

36. John Piggott, John Whalley and Randall Wigle, "International Linkages and Carbon Reduction Initiatives," in Anderson and Blackhurst (eds.), *The Greening...*, op. cit.

37. Peter Emerson and Elizabeth Wallace Bourbon, "The Border Environment and Free Trade" (Environmental Defense Fund, Austin, Texas, for the North American Institute, November, 1991).

is inconclusive; Grossman and Krueger conclude that differences in environmental control costs do not explain the composition of maquiladora production, but several studies have documented some severe environmental problems in the border region. *Ex ante* studies suggest that if serious efforts to control greenhouse-gas emissions are undertaken, the effects will be a different order of magnitude. The trade effects will depend in large part on the specifics—production vs. consumption restriction, reallocation of world production through investment flows, the availability of international trading in emission permits, and whether restrictions are tied to the carbon content of fuels. The global warming question, while important, is quite far removed from efforts at regional economic integration.

Environmental Effect of Trade. Turning the question around, one may ask what are the effects of trade or trade liberalization on environmental quality. Very little work has been done, but some preliminary evidence is available.

First, it appears that open trade (or investment) regimes may have spared countries some pollution problems. Lucas et al. found that "toxic displacement" has been focused on relatively closed fast-growing economies, and has not been evident in countries open to international trade. One reason might be the different composition of industry, with open developing countries more likely to engage in relatively clean, labor-intensive manufactures.[38] Another reason might be greater access of open economies to new, cleaner technologies. This is given some confirmation in a study of Wheeler and Martin.[39] They investigated the international diffusion and adoption of thermomechanical pulping in the wood pulp industry, a clean technology as compared to chemical-based methods. Their interesting conclusion is that the clean technology was adopted earlier and its use grew faster in countries whose price structure is less distorted, or more open to international trade.

More generally, a number of studies, including the work by Grossman and Krueger and by Lucas et al., have found the inverted U pattern of pollution with respect to per-capita income. Also, a positive relation between open trade regimes and economic growth has been firmly established. This suggests that open trade or trade liberalization, through their positive effects on income levels, may contribute to improvements in environmental quality.

Sector-specific research on the effects of trade liberalization on environmental quality is just beginning. Agriculture is an obvious choice. There are a number of models that estimate the price, production, consumption and trade effects of various liberalization schemes. The next step is to translate the production changes into environmental variables such as a primary resources use (land, water, soil) and intermediate inputs with adverse environmental efforts (fertilizer, pesticides). The final step would be to estimate costs and benefits from the new vector of environmental resource demands, by country and region, to establish welfare changes.

Anderson has made a start.[40] Based on his agricultural liberalization model developed with Tyers, price and production changes by country and agricultural product are estimated. Because producer

38. Lucas et al., "Economic Development...," op. cit.

39. David Wheeler and Paul Martin, "Prices, Policies and the International Diffusion of Clean Technology," in Low (ed.), *International Trade,* op. cit.

40. Anderson, "Effects on the Environment...," op. cit.

prices are higher in developed countries, and because the use of farm chemicals is positively correlated with producer prices, the reallocation of production following liberalization should reduce global chemical use in agriculture. Anderson further argues that a reallocation of labor toward agricultural employment in developing countries might reduce urban environmental problems. Finally, he argues that an agricultural expansion in developing countries is unlikely to cause wholesale destruction of tropical rain forests, on the grounds that the elasticity of land farmed with respect to producer prices is low, a conclusion that appears to be at odds with a study by Lutz.[41] Other studies have documented the environmental problems associated with production and trade policies in the United States and the Common Agricultural Policy of the EC.[42] The conclusion of this initial research is that the high level of domestic and trade distortions contributes to environmental deterioration. By implication, agricultural liberalization will contribute to environmental improvement. Nevertheless, all of the literature cautions that liberalization, in the absence of policies directed at environmental externalities and property rights failures, may aggravate environmental deterioration.

The OECD has commissioned studies of the relation of trade and environment in four other sectors—transport, energy, fisheries, and forestry products. While these studies remain restricted and cannot be quoted directly, three conclusions stand out. First, as in agricultural trade, trade controls can misallocate global use of environmental and natural resources and lead to environmental degradation. Second, trade liberalization itself is seldom if ever the ultimate cause of environmental degradation, but trade liberalization *in the absence of policies that correct externalities and property rights failures* can increase environmental stress. This underscores the need for careful environmental assessment of trade liberalization measures. Third, each sector has unique features—environmental, institution, market structure, and policy—and there is no substitute for detailed studies at the sector level for effective resource management.

Finally, in the study mentioned above, Grossman and Krueger have investigated the likely effects of NAFTA on pollution levels in Mexico. Using the trade/investment model of Brown, Deardorff, and Stern, which estimates production effects by sector, and U.S. EPA Toxic Release Inventory data by sector, they estimate the pollution impact of a FTA with Mexico. Grossman and Krueger find that if trade liberalization alone is considered, there will be a net reduction of toxic release from manufacturing in Mexico. The reason is Mexico's shift out of pollution-intensive sectors (e.g., chemicals) to relatively clean, labor-intensive sectors. If, at the same time, there is an investment component to NAFTA (modeled as a 10-percent increase in Mexico's capital stock), the overall expansion of manufacturing activity overwhelms the composition shift, and there is a net increase in pollution in Mexico's manufacturing sector. There are, of course, serious problems in using U.S. pollution-intensity data to estimate Mexico's pollution profile, and with the failure to model changes in production technology that may accompany new investment. Also the study addresses only pollution from manufacturing. It does not consider environmental effects of NAFTA in the agricultural sector.

41. Ernst Lutz, "Agricultural Trade Liberalization: Price Changes and Environmental Effects," as reported by Runge, "Environmental Effects...," op. cit.

42. Runge, "Environmental Effects...," op. cit; Sutton (ed.) *Agricultural Trade...*, op. cit; P. Faeth et al., *Paying the Farm Bill: U.S. Agricultural Policy and the Transition to Sustainable Agriculture* (Washington, D.C.: World Resources Institute, 1991).

III. Three Regional Agreements

How have trade and environmental objectives been reconciled in three regional economic integration arrangements, the EC, the U.S.-Canada Free Trade Agreement (CUSFTA) and the North American Free Trade Agreement (NAFTA)? What lessons, if any, do these hold for additional integration attempts in the Western Hemisphere?

European Experience

In assessing the EC's experience in reconciling regional free trade and environmental objectives, and the lessons from that experience for future economic integration in the Western Hemisphere, the unique features of the EC must be borne in mind. First, the EC created supranational institutions together with a considerable surrender of national sovereignty, all with the objective of political union. This gives the EC authority and instruments to harmonize trade and environmental policies, features that are not found in the CUSFTA or NAFTA and are unlikely to be part of new Western Hemisphere integration arrangements. Second, and again unlike the CUSFTA and NAFTA, the former EC is a functioning common market with free flow of people from one member country to another. Because citizens of the EC have the right to live and work in the country of their choice, the case for uniform minimum ambient and workplace environmental standards is strengthened. Third, the former EC controlled funds (about 1.2 billion ECU for 1989-93) that can be used to bring up the environmental performance in the poorer members. This control of funds is not present in the CUSFTA, although the availability of financial and technical assistance for Mexico has been an issue in NAFTA. Fourth, the spatial proximity of former EC members meant that transboundary pollution is a more serious concern than is likely to be the case if NAFTA is expanded to other Western Hemisphere countries. Fifth, the physical proximity of countries in the former EC, combined with a high level of intra-EC trade, implied that the customary view of product pollution as principally a problem for the importing and consuming country was weakened. For example, it makes greater sense to develop a uniform EC policy with regard to detergents, or auto emissions, than it would be for the U.S. and Argentina to do so themselves. All these unique features supported greater harmonization of environmental policy in the EC than in Western Hemisphere integration.

Prior to the Single European Act (1987), there was no explicit legal provision for EC environmental action.[43] Actions that were taken were justified under Article 30 of the Treaty of Rome, which granted free movement of goods and services; Article 100, which provided for harmonizing laws that affect the functioning of the common market; and Article 135, which permits the Community to take measures to attain Community objectives not expressly provided elsewhere. Article 30, however, allows exceptions to free movement of goods justified in part on environmental protection grounds.

The Single European Act went further. Article 100 states that Commission proposals with respect to health, safety, and the environment will "take as a base a high level of protection"; Article 130R states that the objectives of Community actions shall be to preserve and protect the environment, protect human health, and to promote the rational use of natural resources. Article 130R goes on to endorse the

43. Commission of the European Communities, *European Community, Environmental Legislation, Vol. 1, General Policy* (Luxembourg: Office of Official Publications of the EC, 1992); *Environmental Policy in the European Community* (Luxembourg: Office of Official Publications of the EC, 1990).

principle of preventive action, the rectification of environmental damage at its source, and the polluter-pays principle. In addition, the Single European Act allowed the Council to take some decisions by qualified majority and allowed members to maintain or adopt more stringent worker or environmental protection laws, provided they were not protectionist.[44]

In implementing its environmental program, the former EC had available nonbinding recommendations and resolutions, binding regulations, and directives. Directives must be implemented by the laws and regulations of member states within specified times. The directive was the main instrument for former-EC environmental policy, and it is a very flexible instrument. In certain cases directives can be very general, setting broad goals and encouraging cooperation, useful in situations when the Council cannot agree on actual pollution limits. More often directives could set environmental quality standards, leaving members latitude in the method of control or specific emission limits for individual polluters. Infrequently, directives set specific effluent or emission standards. The flexibility in interpretation, implementation, and enforcement of directives can also lead to dawdling or circumvention by member states. Examples of EC directives ranged from the protection of migratory birds to prohibition on the import of certain seal pups, reduction of auto pollution, testing of chemicals, control of asbestos, and more.

The main principles underlying former EC environmental policy are of some interest. They include the prevention principle, the polluter pays principle (which supports both trade and environmental goals), and the *subsidiary principle.*[45] This last is especially important. It means that the principal responsibility and authority for decision making should reside at the lowest level of authority that has competence to manage the problem at hand. The implication is that a purely local environmental problem, perhaps a land-use question, should be subject to national or, better yet, local control, and not be subject to EC control. In contrast, transboundary pollution such as pollution of the Rhine would require multimember, or perhaps EC-level decision and control. The implication of the subsidiary principle for regulation of products is that unless serious health or environmental damage or transnational pollution are at issue, member states should be free to establish their own product standards, and harmonization of those standards at the EC level is not necessary. The subsidiary principle, combined with the *doctrine of mutual recognition,* described below, is the EC's attempt to reconcile the desire for free flow of goods *and* maintain the right to establish standards reflecting local (member state) environmental conditions and preferences.

This complicated system is still evolving. The history of EC policy dealing with product standards is instructive. The EC has an obvious, strong interest in harmonizing product standards, including environmentally related product standards, if it is to create a single, unified market. Otherwise the pre-existing web of nationally determined product standards, from the permitted ingredients in food products to safety devices for tractors, would increase production costs and fragment the market, and could be drawn up for covert protectionist purposes. Early efforts at harmonizing product standards at

44. Commission of the European Communities, *European Community Environmental Legislation 1967-1987* (Brussels, EC Directorate General for Environment, Consumer Protection and Nuclear Safety).

45. Hank Folmer and Charles Howe, "Environmental Problems and Policies in the Single European Market" (*Environmental and Resource Economics* 1, 1991). See also Article 130R of the Treaty.

the European Community level were unimpressive, in part because Council directives required unanimity.[46] The situation has improved somewhat since the mid-1980s. The Single European Act states that directives are to be accepted by qualified majority. Furthermore, the Cassis de Dijon decision by the European Community in the mid-1980s supported the emerging *doctrine of natural recognition.* In Cassis de Dijon, the court found that a German law requiring liqueurs to have a minimum alcohol content of 32%, and which prevented the sale of a French liqueur, *Cassis de Dijon,* with an alcohol content of only 15.26%, was not legal because there was no public health justification for the law. In the doctrine of mutual recognition, a member government could maintain its own standards on products produced and sold within its territory, but it could not prevent the sale within its jurisdiction of products that met the standards of other member states unless it could show that the national standard was necessary to protect public health or defend the consumer. In a further elaboration, the Court ruled that a member could not stop the importation and sale of a product containing additives that were illegal in the importing member state but legal in the exporting member state, unless it could be shown that the additive was dangerous and the legislative response was not disproportionate. The German *Reinheitsgebot* setting beer purity standards failed this test.

These innovations in melding free internal trade objectives with the desire to maintain some product standard-setting authority at the national level have had some success. Specifically, the EC no longer needed to concern itself with setting so-called nonessential standards—these can be set at the national level, with mutual recognition assuring free market access for other members. But the doctrine does not extend to regulations of most interest here—those that protect health and environment. As it stood, the EC attempted to set (high) minimum standards, but allow members to set even higher standards if they can be justified as necessary and proportionate.

The Danish bottle bill case was a critical test of the relative priorities of trade and environmental interests. In the early 1980s Denmark passed legislation requiring beer and soft drinks be sold in reusable containers.[47] This disadvantaged other EC producers with a relatively small share of the Danish market. The EC Commission took Denmark to the European Court and argued that Denmark's law was in violation of article 30, in part on the basis that the measure was disproportionate to the environmental objective and that other beverages (e.g., milk) were excluded. The European Court ultimately ruled in favor of Denmark, with the implicit message that trade rules must in some circumstances yield to environmental objectives.

In contrast to the issue of harmonizing product standards within the former EC, the issue of a member seeking competitive advantage by establishing artificially low standards for production pollution has not yet been notably difficult or controversial. While it is true that certain EC directives applied to all EC industrial activity, for example, the directive requiring environmental impact assessment of large-scale and environmentally sensitive projects such as refineries, thermal power stations, and integrated chemical installations, and that some other directives contain detailed effluent and emission standards (such as for asbestos) that were uniform throughout the EC, there was no effort to equalize industrial

46. David Vogel, "Protective Regulation and Protectionism in the European Community: the Creation of a Common Market for Food and Beverages" (mimeo, prepared for Conference of the European Studios Association, George Mason University, May 1991.)

47. OTA, *Trade and Environment,* op. cit.

pollution abatement costs throughout the EC. Individual countries can and do set environmental standards on production that lead to different costs.

There are several reasons why the competitiveness issue has been muted in European regional integration. First, the EC had a directive supporting the polluter pays principle (PPP), and this moderates trade distortions from different financing regimes. Second (as previously noted), industrial pollution control costs are generally a very small fraction of total costs, and the scope for industrial relocation on environmental cost grounds has been perceived as limited. Third, policy makers have apparently accepted the convergence theory of Horst Siebert (also mentioned earlier). The Task Force report analyzing the likely environmental impacts of the Single European Act and EC 92 explicitly notes that the completion of the internal market would facilitate "locational arbitrage" in industrial activity, but over time the low-standards country would suffer increasing pollution and would have incentive to raise environmental standards. This would lead to *ex post* convergence through a "competitive process."[48] Compared to the NAFTA process, this reliance on market-based convergence in the EC is a remarkably sanguine view of the environment-competitiveness issue.

Muted attention to the competitiveness issue may not continue. The Single European Act provided for EC-level authority to set community-wide environmental policy as it relates to production pollution, and it may become more active in exercising that authority. The prospective expansion of what is now the EU, and the extension of commercial agreements with Eastern European countries whose environmental standards have been notoriously lax, may be the trigger for a more activist policy. Specifically, in March 1991 what was then the EC announced a two-stage program aimed at harmonizing environmental policy.[49] In the first stage, certain minimum antipollution measures would be established, with stricter voluntary standards by individual member states. In the second stage, all EC members would have to meet a set of standards corresponding to the highest level that could be "reasonably envisaged in light of the latest scientific and technological findings." The extent to which this proposed plan is motivated by competitiveness concerns is not known.

Finally, for completeness, we should mention that the EC discovered an issue raised in Section I of this paper, the impact of regional trade liberalization on the European environment. The Task Force Report is mainly directed toward this question, and additional work at the OECD is looking at particular sectors in the EC such as transportation and energy.

To summarize the EC experience:

Issue 1. Environmentally Related Product Standards. This proved contentious. Despite Community-level political institutions and authority, and a desire to create a single market, the EC did not find it feasible to set single, harmonized standards throughout the Community.

48. European Community Task Force, *Task Force Report on the Environment and the Internal Market* (Brussels: European Commission, 1989), pp. 8.8, 8.9.

49. *International Environmental Reporter*, April 10, 1991, p. 187.

Issue 2: Environmentally Related Regulation of Production. This was not contentious, and there was no serious effort at equalizing environmental control costs within the region. However, this may change in the future.

Issue 3: The Environmental Effects of Regional Trade Liberalization. This question was not considered in the early years of the EC. It was studied in connection with EC-92, and one supposes that when negative effects are identified, the Community will attempt to address them.

The United States-Canada Free Trade Agreement

Despite—or perhaps because of—strong trade and investment links, the United States and Canada have had a long history of commercial disputes. The U.S.-Canada FTA is largely an effort to resolve these disputes. The U.S. and Canada have also have a long history of environmental and natural-resource management disputes. What is perhaps remarkable from the vantage point of 1992 is that questions of environmental protection and natural resource conservation played such a small role in the FTA negotiations, and the potential for conflict between trade and environmental protection, so dominant in the NAFTA process five years later, apparently was scarcely considered, at least by the governments concerned.

The formation of the FTA served to achieve three objectives. First, the U.S. was increasingly frustrated during 1982-1984 in its efforts to launch a new round of multilateral trade talks under GATT auspices.[50] It saw the FTA as an alternative vehicle for moving trade liberalization ahead while the GATT process chugged on. Second, there was a genuine desire among policy makers and parts of the business communities in both countries to secure the advantages of liberalized trade and investment on a regional level. This was perhaps more intense in Canada, which maintained a rather high level of protection for its industrial sector and needed trade liberalization to improve global competitiveness.

Third, and equally important, both governments wished to minimize or eliminate certain product-specific frictions that marred commercial relations. Chief among these were

(1) disputes in energy trade;

> Canada cut oil exports to the U.S. at the time of the first Arab embargo, sought to terminate energy exports and limit foreign investment in the energy sector, and engaged in differential pricing of domestic and export sales in natural gas and electricity; the U.S. at various times controlled well-head prices for natural gas to the disadvantage of Canadian suppliers, denied low-cost Alaskan crude to Canadian refiners, and

50. At the 1982 GATT Ministerial Meeting, the U.S. failed to get a firm commitment for a new trade round. The Uruguay Round was finally launched in 1986.

abandoned a natural gas pipeline from Alaska that would have traversed Canada.[51]

(2) investment restrictions in Canada;

Canada had introduced the Foreign Investment Review Act in 1973 which, among other provisions, established a "significant benefit" criterion for new foreign investments in Canada and encouraged firms to make minimum export and local content commitments.[52]

(3) a series of rather bitter antidumping and countervailing duty disputes; and

The most famous was the alleged low stumpage fees for Canadian softwood lumber, which the U.S. argued amounted to a countervailable subsidy, and the resolution of which proved to be a political prerequisite for the U.S. to finalize the CUSFTA.

(4) increasing strains in the 1965 Automotive Products Trade Agreement

Under the Auto Pact, Canada operated a duty remission plan in which non-North American producers in Canada (Japan and Germany) received a duty waiver for their imports into Canada if they produced and exported from Canada, a device the U.S. properly viewed as an export subsidy.

Although natural resources were central to two of these four dispute areas (energy and softwood lumber), the issues were not identified or presented as environmental or conservation questions.

U.S.-Canadian environmental and resource disputes have covered a wide spectrum. Examples go back to the Trail Smelter Case (1935) in which emissions from a Canadian smelter were found to be damaging the U.S. environment. The dispute was resolved by international arbitration, and it became an important precedent in international environmental law. Subsequent examples include joint pollution of the Great Lakes, acid rain (mainly from the U.S. to Canada), North Atlantic fishing rights, and two GATT Article XX cases involving fish (a U.S. ban on tuna imports from Canada and a Canadian restriction on export of herring and salmon). The most politically sensitive of these issues at the time the CUSFTA was being negotiated was acid rain.

Despite numerous environmental and natural-resource controversies, and despite the fact that the CUSFTA made major policy changes in energy trade, it does not appear that environmental concerns played more than a minor role in the CUSFTA. With regard to competitiveness, there was no attempt

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51. Philip Verleger, "Implications of the Energy Provisions," in Jeffrey Schott and Murray Smith (eds.), *The Canada-United States Free Trade Agreement: The Global Impact* (Washington, D.C.: Institute for International Economics, 1988).

52. Jeffrey Schott and Murray Smith, "Services and Investment," in Schott and Smith (eds.), *The Canada-United States...*, op. cit.

to harmonize environmental standards or environmental costs related to production. This may be because the disparity in standards or costs was minor (Canadian public pollution control expenditures measured as either a percent of GDP or per capita exceeded U.S. expenditures for the decade 1976-1986. Comparative data on private expenditures are not available.).[53]

It is not accurate, however, to say that environmental concerns were entirely absent, especially in Canada.[54] Anticipating fears of U.S. environmentalists that NAFTA would lead to a weakening of U.S. environmental standards, some Canadian environmental groups did oppose the FTA, as did the New Democratic Party, partly on environmental grounds. Apparently, however, it was difficult to produce evidence that U.S. practices were at lower standards. Although ultimately unsuccessful in modifying the FTA, Canadian environmental groups made a vigorous case against the FTA by using many of the arguments that would surface in NAFTA. They have since argued that the FTA, in its implementation, has undermined Canadian environmental protection.[55]

With regard to product standards, the CUSFTA follows GATT language and allows countries to establish domestic standards as they perceive their national interest.[56] The FTA does, however, encourage harmonization and establishes a consultative process to facilitate harmonization.[57] Moreover, the FTA offers a choice of venues for bringing disputes. As mentioned in footnote 20 above, a GATT dispute settlement panel had found Canada's prohibition against export of unprocessed herring and salmon inconsistent with GATT, as it was not primarily aimed at the conservation of exhaustible natural resources (Article XX). Canada accepted the panel decision in 1988, but in 1989 introduced new regulations requiring landing of certain salmon and roe herring.[58] The U.S. disputed the new regulations and chose to bring the question before a CUSFTA panel. That panel ruled in favor of the U.S. A second case brought before an FTA panel involved a U.S. law setting minimum size for lobsters imported or sold in the U.S. Canada objected on the grounds that the regulation violated GATT Article XI, and could not be justified under Article III (permitting internal regulatory measures that do not favor domestic over imported products). The majority of the panel agreed with the U.S. position.

With regard to the two remaining issue areas identified in Section I—the environmental effects of trade liberalization and the use of trade measures to secure international environmental objectives—it

53. OECD, *Pollution Control...*, op. cit.

54. G. Bruce Doern and Brian Tomlin, *Faith and Fear* (Toronto: Stoddart, 1991).

55. Steven Shrybman, "Selling Canada's Environment Short: The Environmental Case Against the Trade Deal" (Toronto: prepared for Canadian Environmental Law Association); Steven Shrybman, "Selling the Environment Short: An Environmental Assessment of the First Two Years of Free Trade Between Canada and the United States" (Toronto: prepared for Canadian Environmental Law Association, May 1991).

56. Specifically, the CUSFTA incorporates GATT Articles XI and XX.

57. The government of Canada has challenged U.S. asbestos regulations as a violation of GATT and CUSFTA obligations, claiming the rules are not "necessary." Also, the U.S. has investigated Canadian subsidies for pollution abatement in the nonferrous metal industry under the implementing provisions of the CUSFTA. Shrybman, "Selling the Environment Short...," op. cit.

58. OTA, *Trade and Environment...*, op. cit.

seems fair to say they played no significant role in the CUSFTA. There was no environmental impact assessment of the CUSFTA. There appears to be no attempt by the government of either country to use the CUSFTA as a vehicle for altering environmental policy in the other country.

The Environmental Issue in NAFTA

Environmental concerns have been dominant in the NAFTA process and only a brief review can be included here. There are a number of reasons why such concerns has been prominent in NAFTA, in contrast to the CUSFTA. First, the disparity in labor costs automatically raised the competitiveness issue. Second, the disparity in environmental standards and enforcement between the United States and Mexico is far greater than between the U.S. and Canada, reinforcing concern for the competitiveness issue. The potential for a Mexican "pollution haven" had greater credibility. Third, serious transboundary air and water pollution problems have been documented and publicized. Because U.S. trade law for many years allowed partial free trade and encouraged the development of the maquiladora industrial plants, and because the ensuing pollution problems had been left untended, full free trade without environmental control was seen to pose an even greater problem. Fourth, the concurrent tuna-dolphin dispute with Mexico increased concern among environmentalists for addressing the trade-environment question. Finally, the Bush administration's need to secure an extension of fast-track authority from Congress in Spring 1991 provided the opportunity for U.S. environmental groups to press for inclusion of environmental measures in NAFTA and parallel arrangements.

Environmental groups in the U.S. (and some in Mexico) had four broad objectives: First, to secure border clean-up; second, to maintain the independence and integrity of United States environmental and health standards as they relate to products; third, to use the NAFTA negotiations to improve general environmental policies (particularly enforcement) in Mexico; and fourth, to demonstrate that trade agreements could in fact be "greened" to a degree not perceived as present in GATT.

The Bush administration wanted to keep NAFTA essentially a trade and investment agreement, but recognized that it must take the environmentalists' concerns seriously. It committed itself in May 1991 to an "action plan" that included (a) parallel negotiations to develop a plan for solving border environmental problems, (b) a commitment to undertake an environmental review of the consequences of U.S.-Mexico trade, (c) a pledge to exclude from U.S. markets products that do not meet U.S. health, safety or environmental standards, and (d) a commitment to appoint environmental representatives to trade and advisory boards.[59] Although the administration had pledged that it would include environmental issues related to trade in NAFTA, the governments of the U.S., Canada, and Mexico wished to keep environmental measures as unconnected to NAFTA as possible.[60] This has been termed the "parallel track" approach.[61]

59. Gary Hufbauer and Jeffrey Schott, *North American Free Trade* (Washington, D.C.: Institute for International Economics, 1992).

60. Charnovitz, "Environmental and Laborer Standards," op. cit.

61. OTA, *Trade and Environment...*, op. cit.

The results of these efforts can be touched upon only briefly here. In February 1992 the United States Environmental Protection Agency and its counterpart Mexican agency, SEDUE, released their joint border clean-up plan, and the U.S. released its interagency review (coordinated by the U.S. Trade Representative) of the trade-environment links with Mexico.[62] The administration has also indicated it would seek $241 million for border clean-up for fiscal 1993. The three governments completed NAFTA negotiations in August 1992, and a final text was ready by September).

The environmental provisions of NAFTA include the following.[63] First, NAFTA states as a primary purpose the promotion of sustainable development, and the expansion of trade in a manner consistent with environmental protection and conservation. Neither "environment" nor "sustainable development" is explicitly mentioned in GATT. Second, with regard to product standards, although it encourages members to harmonize their standards upwards, NAFTA affirms the right of members to choose the level of protection that each considers appropriate and allows them to adopt standards and sanitary and phytosanitary measures more stringent than international standards, but requires that the standards have scientific basis. In the event of disputes, parties have a choice of venue (GATT or NAFTA), the burden of proof is placed on the complaining party, and the dispute settlement panel may call on scientific experts.

Third, with regard to competitiveness and related "pollution haven" question, NAFTA states that it is inappropriate to encourage investment by relaxing health, safety, or environmental measures, and a Party should not "waive or otherwise derogate from, or offer to waive or derogate from, such measures as an encouragement for the establishment, acquisition, expansion or retention in its territory of an investment of such investor." While this last provision may catch the most blatant cases of foreign investment seeking relief from environmental regulations, it does not directly address the possibility that the regulations themselves are drawn up with a view to offering a low environmental cost location for production. NAFTA does permit environmental screening of new investments.

Fourth, with regard to using trade measures to secure international environmental objectives, NAFTA explicitly states that the trade obligations of some specified international environmental agreements (endangered species, ozone depletion, hazardous wastes) will take precedence over NAFTA's provisions, although this is subject to some qualifying language. This provision is in anticipation of a challenge in GATT to using trade measures for international environmental purposes.

Finally, it should be mentioned that in September 1992 the governments of the United States, Canada, and Mexico agreed to establish a North American Commission on the Environment, one function of which would be to facilitate effective implementation of NAFTA's environmental provisions.

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62. The review concluded that NAFTA will enhance environmental protection by providing Mexico with additional resources, ease environmental problems at the border as activity in Mexico shifts southward, and would not encourage U.S. firms to seek lower environmental cost location in Mexico as pollution abatement is a small share of total production costs in most industries. USTR, "Environment: The North American Free Trade Agreement" (Washington, D.C.: USTR, August 1992).

63. See "Description of the Proposed North American Free Trade Agreement" prepared by the Governments of Canada, U.S. and Mexico, August 12, 1992; and testimony of Stuart Hudson on behalf of National Wildlife Federation before the Subcommittee on International Trade of the Senate Finance Committee, September 16, 1992.

IV. Summary, Conclusions, and Implications for Western Hemisphere Economic Integration

Summary and Conclusions

Section I of this paper reviewed relevant theory and concluded: (1) environmental resources are an additional determinant of comparative advantage and a source of gains from trade; (2) subject to certain caveats, attempts to equalize environmental control costs would misallocate resources and be inefficient; (3) trade measures are not the first best instruments for achieving environmental objectives and, if used, may or may not improve welfare; (4) effective control of transboundary pollution is likely to require side payments or sanctions, and an "easy" choice might be trade inducements or trade coercion; and (5) political economy suggests that environmental and protectionist interests may overlap.

Section I also presented a fourfold taxonomy of trade-environment issues:

- competitiveness,
- environmentally related product standards,
- use of trade measures for international environmental purposes, and
- environmental impacts of trade and trade liberalization.

The section then argued that regional economic integration increased the saliency of all four sets of issues.

Section II reviewed GATT treatment of three of these four issues (GATT does not directly concern itself with the environmental impact of trade or trade liberalization). It concludes that (1) there are four unresolved issues in GATT with respect to product standards; (2) GATT addresses the competitiveness issue through its subsidy and countervailing duty provisions, but with considerable ambiguity; and (3) the trade provisions of some international environmental agreements may be inconsistent with GATT, but they have not yet been challenged. Section II also reviews empirical studies of trade, investment, and environment and concludes that (1) the literature through 1990 found minimal trade/investment impact of differences in environmental policies; (2) in more recent studies some effect on trade and industrial relocation cannot be ruled out, but such effects may be either a desirable reallocation of production, in conformity with comparative advantage, an artifact of changing industrial composition in the process of development, or a result of relatively closed trade and investment policies in some developing countries; and (3) studies of the effect of trade on the environment are in their infancy, and the impact can be positive or negative, the latter being more most likely if environmental policy is deficient at the national level.

Section III reviewed the experience of the EC, the U.S.- Canada FTA, and NAFTA. It concludes that (1) the EC continues to grapple with the problem of harmonizing product standards through the subsidiary principle and the doctrine of mutual recognition; (2) harmonizing environmental regulation of production to equalize competitive position has not yet dominated EC policy; (3) the CUSFTA was reasonably free of environmental concerns (product standards, competitiveness issue), and the CUSFTA made no serious effort either to resolve bilateral environmental/resource disputes or to anticipate the environmental effects of trade liberalization; (4) environmental concerns have been prominent in NAFTA for quite obvious reasons including border problems and a concern for the encouragement of pollution havens; (5) the governments' strategy in NAFTA was to establish a parallel track to address environment to the extent possible; and (6) NAFTA has indeed become a "greener" trade agreement because of pressures from environmentalists.

Implications

What does this analysis suggest for future Western Hemisphere economic integration?

(1) Unlike the EC, which aimed at a very high level of economic integration and in which supranational political institutions were established, regional free trade arrangements in the Western Hemisphere will be looser in nature. This suggests that the case for strict a priori harmonization of members' environmental regulations and policies is not as compelling, nor will the political conditions and institutions for such harmonization be present.

(2) Because of the dominance of the U.S. economy in a regional market, there will be further convergence of environmentally related product standards for traded goods toward U.S. levels. This will be mainly market driven, although it would be sensible to negotiate improved procedures for product testing and certification. The EC approach of *mutual recognition* of product standards does not seem appropriate for Western Hemisphere integration. The NAFTA approach, reserving ultimate standard setting authority at the national level, provides a better model.

(3) The case for harmonizing environmental regulations of production to equalize environmental control costs internationally is weak on theoretical and practical grounds. While a concern for loss of competitiveness was present in the NAFTA negotiations, it should be less intense in negotiations with countries whose actual and potential trade with the U.S. is relatively small and who are less likely to become major host countries for U.S. investment. The argument that NAFTA would create a "pollution haven" in Mexico had a modicum of credibility; an FTA-induced pollution haven elsewhere in the Western Hemisphere does not.

(4) Transboundary pollution problems have been significant in the EC as well as in U.S.-Canadian and U.S.-Mexican relations. For reasons of geography, such problems are much less likely to play a prominent role in negotiating free trade agreements with other Western Hemisphere countries.

(5) Points 2, 3, and 4 suggest that environmental concerns may play a lesser role in any expansion of NAFTA. Nevertheless, the occasion of negotiating Western Hemisphere free trade agreements will provide the *opportunity* to press other countries to improve their environmental performance. The success of the U.S. environmental lobby in including the issue in NAFTA will intensify this pressure, and it is likely to be controversial. While some outside pressure, using trade liberalization as the carrot, may be productive, there are limits to how far a liberal trade system should be used to secure noncommercial (i.e., environmental) objectives. There is a genuine concern for not allowing "environmental imperialism" to corrode trade negotiations.

(6) NAFTA demonstrates that it is possible to write a trade agreement with some environmental sensitivity without subverting the main trade and investment liberalization

objectives. For this reason NAFTA may provide a workable model for additional trade agreements in the Western Hemisphere.

(7) Regional liberalization of trade will affect the level and composition of production and consumption, and hence demand on environmental resources. These effects may be positive or negative. It would be sensible to anticipate them for resource management purposes. This will require much improved modeling of the interaction between trade liberalization and demand for and stress on environmental resources; a searching review of national environmental policies directed at correcting externalities and property rights failures; and a change in government policies that inadvertently increase environmental stress (e.g., energy, agricultural chemical and water subsidies).

(8) Trade liberalization is likely to be accompanied by increased foreign direct investment. Potential WHFTA members need to review or establish policies related to foreign direct investment to insure adequate environmental performance.

(9) The policy reforms recommended in points (7) and (8) are desirable whether or not there is further Western Hemisphere economic integration.

IV. Country Perspectives

WESTERN HEMISPHERE FREE TRADE: GETTING FROM HERE TO THERE

Sidney Weintraub

Introduction

Progress toward free trade for the hemisphere is likely to be slow for reasons centered in the political and economic situations in both the United States and Latin America and the Caribbean (LAC). When Chile proposed to start the time-consuming process on the "fast track," the suggestion was rejected on the grounds that the negotiations at a time was all the Congress wished to undertake. Other than Mexico and Chile, few LAC countries are ready and economically able to open their markets to free trade with the United States.

Any achievement of a Western Hemisphere Free Trade Agreement (WHFTA) would be the result of a process that has already begun. The United States' part in this process includes entering into a free-trade agreement (FTA) with Canada, negotiating the North America Free Trade Agreement (NAFTA), and entering framework agreements with all LAC countries other than Haiti, Suriname, and Cuba, either individually or by groups. The LAC counties are playing their part by making drastic changes in development policy, in particular opening their markets to imports and seeking to revitalize subregional economic arrangements. Without these steps on both sides, the U.S. proposal for Western Hemisphere free trade has little hope of achievement. The proposal was in fact greeted with great initial enthusiasm by most LAC countries.[1]

The FTA's path and accomplishment are uncertain. There are many paths and many potential final outcomes. Getting from here to there—and there must be some kind of "there," a WHFTA or something short of that—is the theme of this paper. It will summarize the Western Hemisphere's state of economic integration to set the stage for discussion of potential benefits for the various parties. These sections serve as background for recent developments in the hemisphere.

This paper is directed at process and institutions and does not undertake an elaborate analysis of the benefits and costs of free trade. The following two sections contain the core of the discussion. The first explores the sequencing of movement toward free trade, whether by subregions or individual nations, with NAFTA as the core of a WHFTA, and how to overcome problems of costs to specific nations and subregions. The second discusses the institutional framework that is likely to be required as the process unfolds. The paper concludes with suggestions about options for sequencing and for institutions.

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1. Peter Hakim, "President Bush's Southern Strategy: The Enterprise for the Americas Initiative," *Washington Quarterly*, vol. 15, no. 2 (Spring 1992), notes (p. 93) that Enrique Iglesias, President of the Inter-American Development Bank, referred to the EAI as perhaps the most ambitious proposal in the LAC region's relations with the United States.

Economic Integration in the Americas

Interest in economic integration arises from developments in the region and on other continents. Free trade between the United States and LAC countries is an outgrowth of a shift in U.S. policy toward bilateralism and regionalism. This shift can be explained by the growth of regionalism in Europe ("If regionalism has a beneficial economic outcome there, then why not in the United States' back yard?"), persistent U.S. trade deficits that reflect the increasingly competitive nature of the world economy, and frustration with the workings of the General Agreement on Tariffs and Trade (GATT).[2] The change in policy is evident in the two free-trade agreements (FTAs) the United States has struck, with Israel, Canada and Mexico. It is now conventional (but not unanimous) wisdom that regionalism and globalism in trade can be pursued simultaneously.[3] This paper proposes a somewhat different argument, that regionalism is here to stay, at least for the indefinite future, and so it is essential to make it compatible with globalism if globalism is to succeed.

For more than a century, United States economic regionalism found its main expression in the establishment of a large national market. Regionalism among LAC countries goes back to Bolivar and emerges again in its economic manifestation after World War II as a way to widen the scope for import substitution. What is new for the LAC countries is the acceptance of regional trade and economic arrangements with the United States. This is not the first time the United States has made a proposal for Western Hemisphere free trade, but it is the first time such an initiative has been taken seriously.[4] The main reason for the change is the transformation in development policy from looking inward to seeking extraregional markets for LAC exports; and what better market than the United States, by far the region's largest export destination? Figure 1 illustrates the importance of the United States as a market for the major LAC exporters. The country's dominance in the exports of Canada and Mexico helps explain why they were the first to seek FTAs with the United States.

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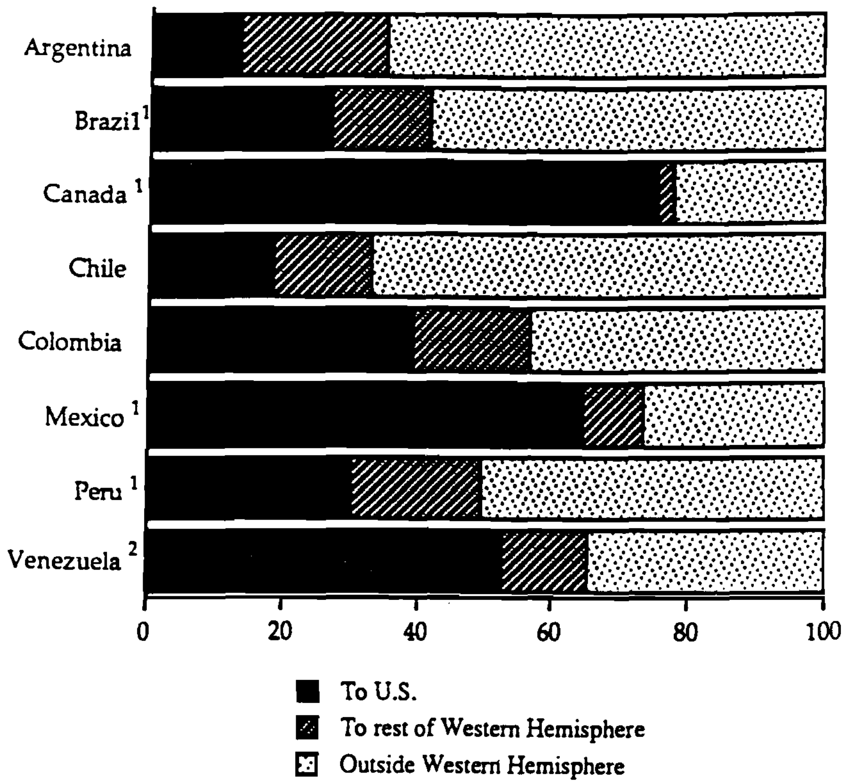
2. Sidney Weintraub, "Regionalism and the GATT: The North American Initiative," *SAIS Review,* vol. 11, no. 1 (Winter-Spring 1991), p. 46.

3. For example, see the explicit statement to this effect in Richard Feinberg, "Economic Themes for the 1990s," in Henry Hamman, ed., *Setting the North-South Agenda: United States-Latin American Relations in the 1990s*, proceedings of conference plenary sessions (University of Miami: North-South Center, 1991, p. 34.

4. U.S. Secretary of State James G. Blaine proposed the formation of a hemispheric free-trade area at the Washington Conference of American States in 1889-90. The suggestion was peremptorily dismissed by the Latin American representatives.

Figure 1
Share of Exports to the United States
of Selected Western Hemisphere Countries, 1988
(Percent of total exports)



[1] Data are from 1987.
[2] Data are from 1986.

Source: Erzan and Yeats, p. 7.

The 1980s were the stimulus for substantial changes in economic policy—from closed to more open economies, from state-dominated planning to greater scope for private enterprise, and from what one commentator called "defensive nationalism" (a third approach to economic policy that was neither capitalism nor socialism) to greater reliance on markets.[5] The primacy of economics as the centerpiece of international policy in the LAC countries reflects events in the United States as its competitive position weakened.

5. Isaac Cohen, "Economic Questions," in G. Pope Atkins, ed., *The United States and Latin America: Redefining U.S. Purposes in the Post-Cold War Era* (Austin, Texas: Lyndon B. Johnson School of Public Affairs, 1992), p. 28.

The dramatic shift from extreme protectionism to open markets has not been uniform among all LAC countries, but greater import openness and export promotion are found everywhere. Nine LAC countries now have tariffs that average below 20 percent, compared with levels as much as five times greater a decade ago. In the case of Mexico, the trade-weighted average tariff is about 10 percent. These tariff levels are still higher than those of the industrial countries, but they are no longer generally intended to exclude imports. Their further reduction over an extended transition period would no longer be traumatic. Nontariff barriers such as prior import licensing have also been dramatically reduced.[6] It was these changes, made unilaterally by LAC countries, that made possible the free-trade initiative by Mexico, the request for free-trade negotiations with the United States by Chile, and the contemplation of hemispheric free trade on the part of LAC countries.

This is a key point, one to which the argument of this paper will refer throughout. Only after a country has accomplished internal restructuring to adapt to an open economy can it contemplate free trade with any hope of accomplishing that transition in a reasonable number of years after conclusion of an agreement.

In addition, the shift in mentality from protectionism—safeguarding generally small markets and small production runs—to playing a larger role on the world economic scene has served to reinvigorate regional integration among LAC countries (Table 1). However, the integration agreements in the Western Hemisphere are a crazy-quilt of cross-memberships and nests of small arrangements within larger agreements: membership in the Andean Common Market (ANDEAN) overlaps that of the Latin American Integration Association (LAIA). So does the membership of the Southern Cone Common Market (MERCOSUR) and LAIA. Mexico is a member of LAIA, has a free-trade agreement with Chile, has negotiated to become a member of NAFTA, and is conducting integration talks with Venezuela and Colombia on the one hand and the Central American Economic Community (CACM) on the other. Venezuela and Colombia have approached the United States about possible free-trade talks even as they retain membership in LAIA and ANDEAN, and they are negotiating separately with Mexico.

This proliferation of economic integration schemes and multiple memberships will have to be sorted out. Each arrangement has its own rules, and the rules are not always consistent. This complex structure must give way to something more coherent if the process of hemispheric trade integration is to advance further. This theme will reappear in the discussion of sequencing of trade and institutional arrangements.

Despite the invigoration and proliferation of economic integration schemes, intraregional trade among LAC countries is not extensive. Figure 1 shows how much more important the U.S. market is to LAC countries than are their markets of the rest of the hemisphere. There are some exceptions: Bolivia, Paraguay, and Uruguay send a larger share of their exports to other South American countries than to the United States.[7] Figure 2 shows the relatively small proportion of intra-trade of Western Hemisphere groupings.

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6. These figures come from David R. Malpass, Deputy Assistant Secretary of State for Inter-American Affairs, testimony on U.S.-Latin American relations before the Joint Economic Committee, U.S. Congress, April 2, 1992.

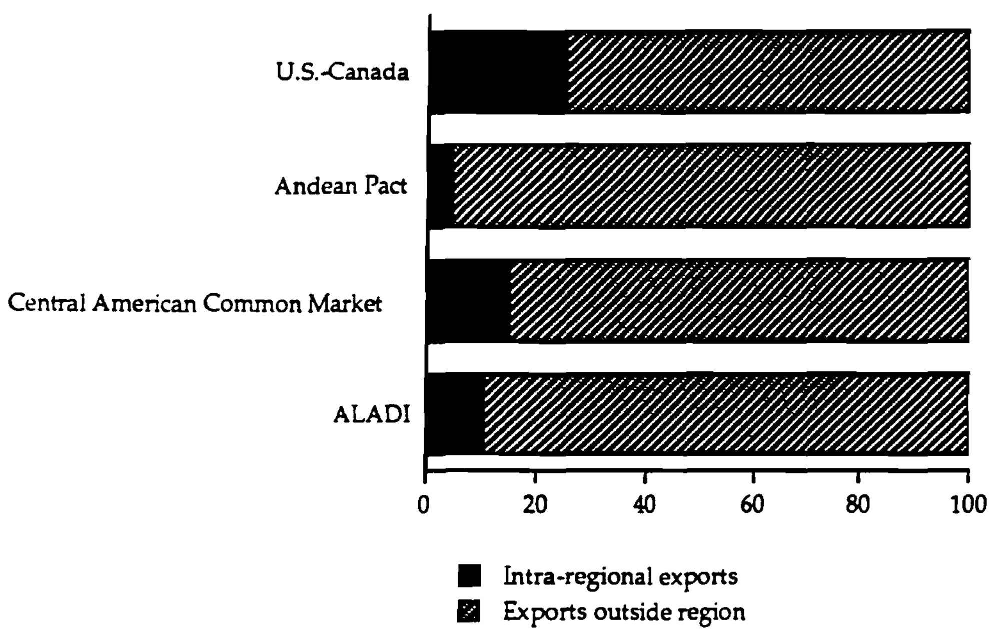
7. Refik Erzan and Alexander Yeats, "Free Trade Agreements with the United States: What's In It for Latin America?" World Bank policy research paper WPS 827, January 1992.p. 7.

Table 1
Integration Movements in the Western Hemisphere

Movement	Established	Timetable
ALADI	1980	Ultimate goal is Latin American common market
ANCOM	1969	Common external tariff 5-20% in 1992
MERCOSUR	1991	CET by 1995
CACM	1960	Free trade zone and common trade policy, 1992
CARICOM	1973	Tariffs range 5-45%, CET by 1994
CUSFTA	1989	Transition to free trade by 1992
Chile-Mexico	1991	Remove all tariffs and many NTBs by 1998
NAFTA	1993	10-15 year transition to free trade beginning 1994

Source: Council of the Americas, *Washington Report*, winter 1992; and de la Torre and Kelly

Figure 2
Intraregional Exports of Western Hemisphere Groupings, 1990
(Percent of grouping's total exports)



Source: de la Torre and Kelly, pp. 20 and 30.

The LAC countries still account for a relatively modest share of U.S. exports. U.S. exports to Canada, with a population of 27 million, are greater in value than exports to the rest of the Western Hemisphere, of which the population is 450 million. U.S. exports to Mexico (population about 83 million), while only about 40 percent of its exports to Canada, are more than to all other LAC countries combined. The question asked by Erzan and Yeats is; What's in free trade with the U.S. for the LAC countries?[8] There is also the reverse of the question: What's in it for the United States other than the potential for significant exports to a few countries in the hemisphere? And there is a final question: What's in it for Canada?

Table 2
U.S. Exports to Western Hemisphere Countries, 1991
($ million)

Canada	85,103
Mexico	33,276
Caribbean	6,189
Central America	4,273
South America	19,227
Other	506
World	421,614

Source: U.S. Department of Commerce, *U.S. Foreign Trade Highlights, 1991.*

The Benefits of Hemispheric Free Trade

United States Interest

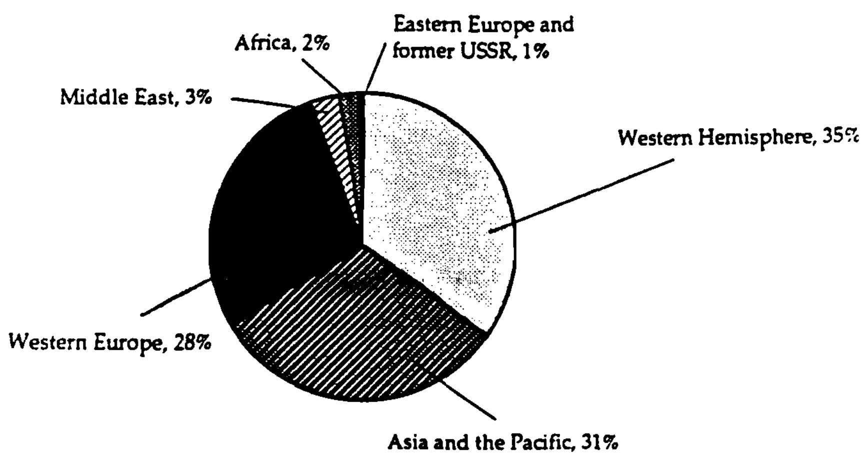
U.S. merchandise exports are widely dispersed (Figure 3). Western Hemisphere countries in 1991 received 35 percent of U.S. merchandise exports, most in North America. Canada and Mexico together took 28 percent. Put differently, 80 percent of all U.S. merchandise exports to Western Hemisphere countries ($118 billion) went to Canada and Mexico; the rest of the Western Hemisphere accounts for only $30 billion. The static picture, therefore, does not demonstrate that the United States should have great interest in expanding NAFTA to the rest of the Western Hemisphere. If anything, a snapshot of U.S. exports in 1991 would imply that the U.S. free-trade interest after North America should focus on Asia and the Pacific, the destination of 31 percent of U.S. exports.[9]

8. Ibid.

9. This may have been the indirect message of Robert Zoellick, U.S. Under Secretary of State for Economic Affairs, in an address on July 24, 1992, during post-ministerial meetings in Manila of the Association of Southeast Asian Nations. Zoellick said that free trade in North America and in Asia should complement each other and help create stronger pan-Pacific ties.

The dynamic picture is more instructive. U.S. exports worldwide grew (in current dollars) by 7.1 percent in 1991 over 1990. Exports to developing countries in the Western Hemisphere grew by 17.7 percent.[10] This was greater than U.S. export growth either to Asia and the Pacific or to Western Europe, the two other important export destinations shown in Figure 3. This growth of exports to LAC countries continued into 1992. Some of the growth in U.S. exports may have been due to the unilateral liberalization of import restrictions undertaken in recent years by LAC countries. A much more significant explanation, however, is the overall economic recovery of LAC countries.[11]

Figure 3
U.S. Exports by Geographic Region, 1991
(Percent of total U.S. exports)



Source: U.S. Department of Commerce, *U.S. Foreign Trade Highlights, 1991.*

U.S. merchandise exports to LAC countries grew fivefold during the 1970s, and the region's GDP grew at an annual rate of about 4.5 percent. By contrast, U.S. exports to the region grew by less than 50 percent during the 1980s, when GDP growth averaged only about 1.5 percent a year. Exports actually declined on a per capita basis. Discounting for inflation, U.S. exports to LAC countries were stagnant during the 1980s and reflected the economic stagnation in the countries themselves. A large portion of LAC hard-currency earnings and capital inflows had to be dedicated to debt servicing, and this requirement limited resources available for internal economic development and for imports.[12] U.S.

10. U.S. Department of Commerce, *U.S. Foreign Trade Highlights 1991* (Washington, D.C.: International Trade Administration, 1992), p. 11.

11. I base this statement on econometric analysis.

12. Comisión Económica para América Latina y El Caribe (CEPAL), "Preliminary Overview of the Latin American and Caribbean Economy, 1991", information note no. 519/520, December 1991, Santiago, Chile, estimates that LAC debt service as a percentage of exports of goods and services was 22 percent in 1991 compared

producers paid a heavy price to sustain the viability of U.S. financial institutions. The LAC region's economies are now recovering, and their imports from the United States are recovering as well.

A greater share of the imports of LAC countries and Canada comes from the United States than from any other source. The proportion varies by country: 60-70 percent for Canada and Mexico, 40-60 percent for Venezuela and much of Central America, 30-40 percent for Colombia and Ecuador, 20-30 percent for Brazil, Chile, and Peru, and less than 20 percent for Argentina alone among the larger economies. For LAC as a whole, the share of imports coming from the United States, which was 57 percent in 1989, is at least double the share of either Western Europe or Asia and the Pacific. Thus, as LAC countries have become able to afford more imports, the main exporter to benefit is the United States. The same is not true of other regions with which the United States has substantial trade. U.S. imports from Western Hemisphere countries are reflected in large U.S. exports to them in return. U.S. imports from Asia and the Pacific (including Japan) have a far lower reflection ratio in exports back to the countries in those regions. The United States has a major trade stake in the economic health of the LAC region. The economic dynamics of U.S.-LAC relations provide the main explanation for the U.S. interest in a WHFTA.

Moreover, the interest of the United States goes beyond trade. The U.S. is the leading foreign investor in the Western Hemisphere. This is particularly true in Canada and Mexico, but prevails as well in the rest of the hemisphere. Trade has followed investment. Earlier, during the import-substitution period in hemispheric trade, U.S. investment in manufacturing was designed largely to serve the protected domestic market in the host country. This was attractive in the countries with the larger economies such as Canada, Mexico, and Brazil, but less so in the smaller economies.

Trade barriers are coming down, and U.S. multinational corporations have a substantial interest in co-production arrangements in the Western Hemisphere. The very basis for the export processing zones that have proliferated in the LAC countries, especially in Mexico, the Caribbean, and Central America, is to exploit factor advantages—primarily low labor costs—available in these countries. Their proximity also minimizes transportation costs. The shipment of intermediate goods across national boundaries requires low trade barriers. U.S. law already partially provides this since tariffs are levied on such products, imported under subheadings 9802.00.60 and 9802.00.80 of the harmonized tariff schedule, only on the value added outside the United States. Free trade would lead to the elimination of these and other tariffs and also to the easing of nontariff barriers such as quotas.

The United States thus has both trade and production interests in a WHFTA. This interest cannot be based on giving up markets in other regions because, as Figure 3 shows, U.S. merchandise exports are, in broad terms, evenly divided among the Western Hemisphere, Asia and the Pacific, and Western Europe. This distribution of U.S. exports provides an incentive to keep import barriers against third countries relatively low in any WHFTA.

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with proportions in the mid-30 percent range during most of the 1980s. This same source estimates that there were resource inflows into LAC countries of $6.7 billion in 1991, the first time this figure was positive since 1981. LAC's debt problem is by no means resolved, but it does not now have the same devastating effect it did during the 1980s.

Canadian Interest

Canada's interest in Western Hemisphere free trade is less evident. Only about 5 percent of Canada's trade is with LAC countries (Figure 1), and one third of that is with Mexico. The Canadian case has been referred to as "reluctant regionalism."[13] Canada joined the NAFTA negotiations to protect its interests in the U.S. market, but did so with considerable misgiving.[14] Canada is being drawn into the broader regional free-trade process for much the same reason, to protect its trade interests in the United States and its potential interests in LAC countries, plus the desire to prevent a hub-and-spoke outcome. This issue, the way free-trade should be approached in the hemisphere, will be taken up later. It is quite revealing, however, that the phrase "hub-and-spoke" in reference to hemispheric free trade originated in Canada and is heard more from Canadian sources than from elsewhere in the hemisphere. Indeed, as Table 1 shows, LAC countries are quite prepared to move ahead on a hub-and-spoke basis when they are the hubs—the Mexico-Chile free trade agreement is an example of this. The Canadian position against a hub-and-spoke design for a WHFTA is correct, but the issue is not pressing if hemispheric integration continues to follow the path it now seems to be taking. The United States, the country Canada had in mind, has not suggested a series of FTAs in the hemisphere with it alone, but has left open accession to NAFTA.

However reluctant Canada's regionalism may be, if the process prospers, it will have repercussions on its future trade and investment policy in the hemisphere. Western Europe was not seen as a natural trading area before the establishment of the European Community, but the EC is now perceived as a "natural" trading bloc. This natural trading area is growing throughout Europe by grafting additional countries onto the EC. The preferential opportunities a WHFTA can provide should stimulate Canadian businesses to invest in LAC countries and exploit export opportunities. It would be a mistake to assume that past Canadian disinterest in the LAC region would prevail under changed circumstances.

LAC Interest

Defining the interest of LAC is more complex than for either Canada or the United States because of the differences among LAC countries. Mexico's natural market in the United States has been nurtured over the years by U.S. investment, co-production, and regional marketing alliances. This interest is reflected in free trade with the United States—in the creation of NAFTA—but not in a WHFTA, at least not yet. The more countries in the hemisphere that have free access to the U.S. market, the more Mexican preferences will be diluted. Yet for political and cultural reasons, Mexico has muted any expression of misgivings about other LAC countries' joining them in free trade. Indeed, Mexico has embraced the idea by its own free-trade negotiations with them.

The first approach to defining LAC's interest in a WHFTA is to examine the current destinations of exports: How much goes to the United States, and how much to other LAC countries? Figure 1

13. Al Berry, Leonard Waverman, and Ann Weston, "Canada and the Enterprise for the Americas Initiative: A Case of Reluctant Regionalism," *Business Economics*, vol. 27, no. 2 (April 1992), pp. 31-38.

14. Bob Rae, the premier of Ontario, has noted his concern about Canadian vulnerability "on cars, on culture and on two or three other issues." See Karsten Prager and George Russell interview with Premier Rae in *Time*, November 11, 1991, p. 39.

shows relative trade flows for LAC's largest exporters. The countries that should have the greatest interest in hemispheric free trade—that is, free entry into the U.S. market and not just into subregional LAC markets—are Mexico, Venezuela, Colombia, and (to some extent) Brazil. The Central American and Caribbean countries should be added to this list, but the case of Venezuela is tenuous because most of its exports to the United States are petroleum, for which an FTA is not particularly relevant. Less than 20 percent of Colombia's exports to the United States are manufactured goods, and it is for these products that free trade is most important.

Yet both Colombia and Venezuela have indicated strong interest in free trade with the United States. The portion of Chile's exports going to the United States is still relatively small, but Chile was the first country after Mexico to propose an FTA with the United States. The response of LAC countries to free trade with the United States is based on much more than the current destinations of their exports. It is also based on how they want their economies to develop.

A second approach is to examine the tariff and nontariff barriers their exports face in the United States. Erzan and Yeats make this examination and conclude that the countries that export a wide range of manufactured goods (such as Mexico and Brazil) should have the greatest interest in removing U.S. tariffs, whereas the countries that export raw materials, which face relatively few tariff barriers, are likely to have only modest interest in free trade with the United States. They also conclude that the benefits of free trade with the United States would be constrained unless hard-core nontariff barriers (such as those for textiles, clothing, and sugar) are eased or removed as well.[15]

These approaches—looking at current trade patterns or levels of U.S. protection against current LAC exports—are valid, but they do not tell the full story. The levels of cross-national protection between Canada and the United States were quite low before they entered into free trade. The CUSFTA would not have been necessary if the purpose were simply to reduce trade barriers. The composition of Mexico's exports changed radically from the early 1980s, when petroleum dominated, to the dominance of manufactures. The change in domestic development policy in Mexico made the past a poor predictor of the future. In both cases, the initiatives for free trade with the United States were taken on much broader grounds than the current trade and protective situation: to assure continuity of U.S. policy, to provide a psychological incentive for foreign investment, and to link production and marketing between Canada and Mexico (respectively) and the United States, and now among all three in NAFTA.

North American *free trade* is a simplification that borders on being misleading; North American *free investment and trade* might better describe the intent of NAFTA; and not just investment from within North America itself, but from all sources to combine production and marketing in the large North American market. One of the weaknesses of many partial and general equilibrium models projecting the outcomes of free trade either in North America or the Western Hemisphere, particularly the static models, is that investment is either omitted or is not endogenous.

Answering the question, "What's in it for the LAC countries to have free trade with the United States (and with their neighbors in their own subregions as well)?" requires approaching the issue from the viewpoint of the LAC countries' domestic development strategies. Country after country in the hemisphere has concluded that its development requires substantial structural adjustment. This obviously

15. Erzan and Yeats, "Free Trade Agreements with the United States," pp. 18-24.

involves many aspects of macro- and microeconomic policies. The details will differ from one country to another, but the general objectives are thoroughly discussed in the literature and require no elaboration here. One aspect of these new development policies is to induce greater competition through more open markets. It is these policies that are driving external trade and investment measures.

Mexico was able to seek free trade with the United States because it first decided to restructure its domestic economy and to open its market to imports. Chile has done the same. Both countries have made substantial progress in their internal restructuring. Because relative prices in these two countries have been and are being altered for internal development reasons, and because markets have been largely opened unilaterally in order to stimulate competition, seeking reciprocal opening in the U.S. market is almost certain to be a net plus for them.

Both Mexico and Chile first undertook internal restructuring and then sought free trade with the United States. Most other LAC countries are not yet ready to seek free trade with the United States because their domestic adjustments, including the reduction of barriers against imports, are not yet complete. They still have a number of years of restructuring to reach the stage of either Mexico or Chile. These further changes must come before they seek free trade with the United States.

The analysis of "what's in it for" the LAC countries should not be approached the way governments traditionally look at trade negotiations, where every reduction of one's own import barriers is seen as a "concession" to some foreign interest, but instead on broader development grounds. Is it in the national interest of a LAC country to open its market, to restructure its economy? If so, then free trade is a further step that permits obtaining reciprocity.

The Central American and Caribbean countries represent a special case. They enjoy preferential treatment for their exports to the United States, their main market, under the Caribbean Basin Initiative (CBI). Under a NAFTA, these preferences are being shared with Mexico, and under a WHFTA they would have to be shared with other countries in South America. Many of the manufactured products they now export come from export-processing zones and pay duty only on the in-country value added when imported by the United States. This benefit would be diluted (a) as other countries obtain duty-free entry for their products entering the United States, and (b) as the United States gradually eliminates textile and clothing quotas for other free-trade partners, as contemplated in NAFTA. The NAFTA agreement calls for a phased easing of the U.S. sugar quota as it applies to Mexico, and this could work to the disadvantage of Central American and Caribbean exporters unless and until they obtain comparable treatment.

One expert from the English-speaking Caribbean posed a number of questions pertaining to that region. Because of their small size, how many Caribbean countries can meet the criteria (especially markets open to free imports from non-CARICOM countries) that would make them ready to enter free-trade negotiations with the United States? Should they try to meet these criteria? And even if they can, what will happen during the transition when Mexico enjoys preferential treatment in the U.S. market? If they negotiate for free trade with the United States, should they do so individually or as a group? Would the necessary investment come to these countries under free trade? What will happen to the trade preferences these countries receive from the EC under the Lomé convention if they enter an FTA with the United States? Or must preferences granted to the United States also be granted to EC countries?[16]

The Central American and Caribbean countries represent a special case because of their dependence on the U.S. market. Yet the resolution of their problem should not be accession to NAFTA if they are not ready to undertake its obligations. An alternative solution is to augment the one-way preferences they now receive under the CBI to avoid placing them at a disadvantage with respect to Mexico.

Concluding Comment on the Varying Interests

What emerges in this cursory discussion of different national interests in a WHFTA is the difficulty of making general statements that are valid for all countries. For the United States, if one takes a static view, free trade is of interest only with a few countries. The markets of many LAC countries and subregions are relatively small, and the pursuit of free trade with them would require some U.S. political interest beyond expanded exports.

Looked at in reverse, some countries in the hemisphere rely primarily on the United States for their export earnings, but many do not. Based on static analysis, free trade with the United States does not appear to offer much to those countries whose main markets are elsewhere or whose raw-material exports do not face significant trade barriers in the United States. Indeed, some countries (such as those in Central America and the Caribbean) could be hurt if their present preferences in the U.S. market are diluted.

The longer-term view of current trade patterns as well as desired ones may change this outlook. The LAC market is of minor current interest to Canada, but Canada may be forced to become regional in spite of itself. Canada and Mexico now dominate U.S. exports to the hemisphere, but the United States sees a natural trade advantage for itself if hemispheric incomes and imports grow. Chile, Colombia, and Venezuela all contemplate changing the composition of and augmenting their exports to the United States. Chile is ready to move now and Colombia and Venezuela expect to be ready soon. The MERCOSUR countries are not now ready for free trade with the United States, but Brazil and Argentina could become major beneficiaries as the process unfolds.

What is now driving the process—what did not exist during the import-substitution period in the LAC region—is the dramatic change in development thinking, from largely closed to open markets, from looking within to looking outward. The analysis of country interests, therefore, must derive from this philosophic change. Countries or groups of countries will be ready to consider a WHFTA for themselves only as their internal restructuring progresses far enough to make it possible. This has been accomplished only in Mexico and Chile. It will have to take place in other LAC countries if the process of hemispheric trade is to progress.

16. Richard L. Bernal, "A Caribbean Perspective of the Enterprise for the Americas Initiative," paper presented at a seminar on the Caribbean and the Enterprise for the Americas Initiative, Kingston, Jamaica, September 26-27, 1991

Movement Toward Free Trade

The Compatibility of Regionalism and Globalism

The growth of regionalism, in both formal and informal trade and investment arrangements, is disquieting to many trade economists because it must diminish the authority of the more global structure represented in the GATT or in the proposed WTO.[17] Even though regional trade arrangements are authorized in Article XXIV, the GATT and the economist's ideal is still the unconditional most-favored-nation (MFN) rule for the conduct of international trade.

Bhagwati has noted that regional integration, even while it can be consistent with the letter of the GATT, threatens the basic concept of the world trading system envisioned in the GATT.[18] The very purpose of bilateralism and regionalism in the sense discussed here—an FTA—is to favor some countries over others. Whether the result of any regional preferential arrangement achieves the test set forth by Viner, that trade creation should exceed trade diversion, and despite all our sophisticated modeling, it is not always possible to know exactly how much trade is created and how much diverted from third countries. It is no accident that the formation of the European Economic Community spawned the creation of the European Free Trade Association. Preference begets counter-preference. Nor is it an accident that the creation of the EEC led to a clamor for the entry of new countries, or that the CUSFTA stimulated Mexico to act, and that the NAFTA has aroused interest in other LAC countries for free trade with the United States.

Preferential regional arrangements also arouse political hostility. The United States, from the time of its creation as a country until 1923, practiced conditional MFN, that is, it discriminated against countries unless they gave trade concessions in return for nondiscriminatory treatment. The main reason for the shift was that as the United States became a major trading nation, the discrimination inherent in this policy generated substantial political conflict.[19] Viner noted that this conditional application of the MFN clause has probably been the cause in the last century of more diplomatic controversy, more variations in construction, more international ill-feeling, more conflict between international obligations and municipal law and between judicial interpretation and executive practice, more confusion and uncertainty of operation, than have developed under all the unconditional most-favored-nation pledges of all other countries combined.[20]

17. What I have in mind by a more comprehensive organization is the proposal made in the context of the Uruguay Round negotiations to broaden the charter of the GATT to make it reflect what is actually covered in trade negotiations, such as trade in services, trade-related investment matters, environmental issues related to trade, intellectual property, and many other matters. GATT has never been universal, particularly because of the absence of most countries with centrally-planned economies, but, as we know, this situation is changing.

18. Jagdish Bhagwati, *The World Trading System* (Princeton University Press, 1991), p. 58.

19. This is discussed in Sidney Weintraub, *Trade Preferences for Less-Developed Countries: An Analysis of United States Policy* (New York: Praeger Publishers, 1966), pp. 1-22.

20. Jacob Viner, "The Most-Favored-Nation Clause in American Commercial Treaties," *Journal of Political Economy*, vol. xxxii, no. 1 (February 1924), p. 111.

The United States discriminated in its policy of conditional MFN in order to extract the most favorable trade openings by other countries. Regionalism is practiced in order to provide concessions to some countries but not to all. The contexts are different and the instruments are not the same, but the issue of resentment aroused by discrimination is identical.[21]

If ever a task could be called Sisyphean, seeking to roll back the regionalism that already exists is one. The major regional groups in Western Europe and North America each account for abut 30 percent of world GDP, and together they generate some 65 percent of world trade and absorb nearly 50 percent of developing-country exports.[22] And these are not the only regional arrangements in existence. Japan does not have preferential trade arrangements with other countries in Asia, but it is dominant in this trade, in large part because of investment and co-production arrangements.

Countries enter preferential regional arrangements precisely because they are preferential. That is, countries are willing to open their markets regionally more thoroughly than they are willing to open them universally. The conflict within the former EC about completing the common market there and expanding to economic and monetary union or widening the community to include other aspirants brings out this issue with great clarity. Michel Rocard, the former French prime minister, made this point quite explicitly: "European integration is necessary, but it cannot be achieved in every field with the same partner or with the same intensity."[23]

I raise this question because the same issue will arise in the Western Hemisphere. NAFTA, if it comes into existence, is apt to deepen over time, much more than can a free-trade arrangement between the NAFTA countries and those in Central America, the Caribbean, or most other LAC countries. This theme reappears because it is important for the path of hemispheric free trade.

Regionalism is certain to be a fact of life for the indefinite future and may well increase in importance. It will be a complex regionalism, with subregions within regions, and the issue to be decided is the kind of structure that can be created within this complexity. In addition to this awkwardness within regions, conflicts between regionalism and globalism center around the issue of who gets hurt when the sway of unconditional MFN is weakened. The world trading order to be worked out will require minimizing this conflict since there is little prospect of eliminating it. If either element of this dyad is under threat today—and if optimum coexistence is not achieved—the more vulnerable structure is the global one, the GATT, not the regional structures.

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21. See C. Michael Aho, "A Recipe for RIBS — Resentment, Inefficiency, Bureaucracy, and Stupid Signals," in Richard S. Belous and Rebecca S. Hartley, eds., *The Growth of Regional Trading Blocs in the Global Economy* (Washington, D.C.: National Planning Association, 1990), pp. 22-29, for a presentation of this point of view about the current trend toward regionalism.

22. Augusto de la Torre and Margaret R. Kelly, *Regional Trade Arrangements*, occasional paper 93 (Washington, D.C.: International Monetary Fund, 1992), p. 1

23. Michel Rocard, *Europe and the United States* (New York: Council on Foreign Relations Press, 1992), p. 11.

Bhagwati, despite his misgivings about the growth of regionalism, concedes that its current rise will endure.[24] His recommendations to avoid undermining the GATT are to insist on strict interpretation of Article XXIV, granting permission only for customs unions with a bound common external tariff (CET) on the ground that this would probably result in a downward tendency in tariffs, and assuring that any arrangement will be open to new members.[25] Bhagwati suggests that to ensure that a CET leads to lower tariffs, GATT Article XXIV should be changed to require all members of a customs union to adopt the lowest tariff on any item rather than to construct an average of the member countries' tariffs, as is now the practice. The objective of these suggestions is straightforward: regional integration arrangements should minimize margins of preference in order to impose the fewest possible distortions on the system. Few economists would quarrel with the intent of these suggestions.

However, the double suggestion to tighten the provisions of Article XXIV and then interpret them more strictly has elements of futility. Schott has pointed out that GATT examined 69 preferential agreements between 1948 and 1988 (this includes the CUSFTA), and only four minor agreements were deemed compatible with Article XXIV. No agreement was censured as being incompatible with GATT provisions; the Contracting Parties merely submitted reports with no formal conclusions on the other 65.[26] It is by no means assured that a CET will lower tariffs, as Bhagwati implicitly admits in his suggestion to eliminate averaging and to set the CET on particular items at the level of the lowest member. The requirement for a CET has served in some cases to keep tariffs high, for example in CARICOM today and earlier in the CACM. The Canadians preferred an FTA over a customs union because of the belief that the former carried less political baggage. The reality is that if an FTA functions successfully, the pressure will be for tariffs on particular production inputs—that is, raw materials, intermediate products, and capital goods—to equalize at the lowest rate of any of the members. The reason for this is that the member with the lowest tariff would otherwise have a cost advantage in production. The tendency for tariff rates to converge downward in an FTA may not be as strong for finished consumer goods that are not used as inputs for further production.

One theoretical advantage of a CET is that it would eliminate the technical basis for rules of origin in an integration agreement. There would be no need to define products originating in the member countries if the tariff on any given item were the same in all. As we have seen in the NAFTA negotiations, the technical basis for a rule of origin has been transformed into a buy-North-American provision for many items, particularly automobiles and textiles and apparel. However, the EC has not found it difficult to devise other rationales for limiting foreign competition in these and other sectors.

Dornbusch does not agree that bilateralism is necessarily inferior to multilateralism. He has argued that bilateralism got a bad name when it was used to restrict trade, but it can also be used to liberalize trade, as NAFTA and the proposed WHFTA would probably accomplish.[27] The conclusion

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24. Bhagwati, *The World Trading System*, p. 71.

25. Ibid, pp. 76-77.

26. Jeffrey J. Schott, *More Free Trade Areas?* (Washington, D.C.: Institute for International Economics, 1989), p. 27.

27. Rudiger Dornbusch, "U.S.-Latin American Trade Relations," testimony before the Joint Economic Committee, U.S. Congress, April 2, 1992.

coming from this line of reasoning is that regional integration can serve a trade-creating purpose if it lowers barriers more than they would otherwise be reduced. Put differently, this is an argument that a low margin of discrimination in favor of member countries (inherent in bilateralism and regionalism) may be less onerous than high nondiscriminatory barriers.

The logical conclusion is that a theoretical argument about the compatibility of regionalism and bilateralism is futile. The two will coexist, and if they do not, the multilateral structure is the one in greater danger of disintegrating. What remains, therefore, are two requirements: (1) to strengthen the multilateral trading system by implementing the Final Act of the Uruguay Round; and (2) to minimize the effects of regionalism on third countries by reducing protection against them. This protection deals not just with tariffs, but with a whole range of preferences relating to differences in nontariff protection, trade in services, limits on foreign direct investment, entitlements to bid on government procurement, and many other elements of modern integration arrangements.

Managing the Process in the Western Hemisphere

The discussion so far lays out many of the considerations that must be taken into account in structuring the process toward hemispheric free trade. Constraints on the process include:

- Determining the desired structure of free trade, whether hub-and-spoke, a single FTA, or a series of FTAs among the various subregional groups;
- Setting priorities between subregional integration and hemispheric free trade;
- Different objective circumstances of countries or groups of countries (but without slowing progress toward free trade to the speed of the countries least able to act);
- Sorting out the labyrinth of integration arrangements that now exist in the hemisphere;
- Minimizing barriers against nonmember countries; and
- Maintaining the ability for new countries to join (but not thereby thwarting the ability of particular groups of countries to deepen their own integration).

These constraints raise related questions. One of the more complex is whether the requirement that any hemispheric agreement be kept open to new members means that nonhemispheric countries should also be permitted to join. The proposed NAFTA agreement contains no geographic limit on accession of new members. The possibility exists that Australia and New Zealand in particular, and potentially other countries in Asia and the Pacific, might want to become members. The lower the barriers against third countries, the less pressing it is to answer this question, but the issue may arise. Nonregional countries should not be excluded in principle, but the decision whether or not to admit them can be deferred until the process of hemispheric integration has progressed much further. Deferral of the decision is possible because the transition to free trade in NAFTA will require 10-15 years; the process of integration in the Western Hemisphere will take even longer.

A second set of questions relates to the undertakings of member countries of LAIA to each other and of the Caribbean countries that benefit from preferences in the EC under the Lomé convention. In the case of LAIA, the letter of the agreement requires that any concessions granted to nonmember countries be extended to other members of LAIA. Can a country join NAFTA and discriminate against other LAIA countries? In theory, no, unless it withdraws from LAIA. In practice, the assumption is that some way will be found to accommodate countries that wish to remain in LAIA and join in a WHFTA. In the case of Caribbean countries receiving preferences in the EC, the Lomé convention requires them to grant MFN trade treatment to EC countries. Thus, in theory, CARICOM could not join into free trade with the United States without giving free entry to EC countries as well. It is not clear what this will mean in practice. The EC might insist that beneficiaries of Lomé preferences give these up if they become part of a WHFTA.

The most important constraints relate to how countries enter into free trade within their subregions and also with the United States. The initial Canadian concern was that the United States would sign a series of FTAs, country by country, first with Canada, then Mexico, then a third country, and thus only the United States would enjoy generally free trade. This concern over a hub-and-spoke outcome was one of the reasons why Canada joined in the negotiations with Mexico, in order to have a single NAFTA rather than two separate bilaterals. According to Ronald Wonnacott, the main disadvantages of a hub-and-spoke pattern are that it would add to discrimination against spoke countries in each other's markets as compared with the hub country, which would be the only country to enjoy barrier-free entry into all markets; this, in turn, would erode the benefits derived from an FTA with the United States; and, perhaps most crucial, the advantage in attracting investment would be with the hub country.[28] Technically, devising rules of origin in an elaborate array of hub-and-spoke FTAs would be horribly complex. The end result of a hub-and-spoke pattern compared with a single, large WHFTA, Wonnacott argues, would be to lower collective incomes.

The United States is not now a hub country in the sense that Canada originally feared, but Mexico is. The trade consequences are not significant because Mexico's trade with Chile, Colombia, Venezuela, and several Central American counties is not substantial. NAFTA as a unit may be a hub, however. The starting point of the United States as a hub, the concern that led to Canadian analysis of hub-and-spoke arrangements, is not now the major problem. The issue, rather, is how the separate hubs, the subregional arrangements that exist plus Mexico's multiple agreements, are best melded into hemispheric free trade.

The second constraint cited above, that of the relative priority of subregional integration as compared with hemispheric integration, is now more relevant than a simple hub-and-spoke scenario. The most important of the subregional agreements is NAFTA. It has the largest combined GDP and conducts more trade than all the other trading groups in the hemisphere combined. Most important, if the process is intended to lead to a single free-trade area in the hemisphere, NAFTA is the only feasible nucleus around which such a group could come together. Nevertheless, for many LAC countries the focus of attention is on subregional arrangements. For the first time in their modern history, LAC countries are approaching regional and subregional integration by confronting the constraint of minimizing barriers against nonmember countries. There is an effort to use subregional integration as a device to expand trade rather than to augment the scope for import substitution.

28. Ronald J. Wonnacott, *The Economics of Overlapping Free Trade Areas and the Mexican Challenge* (Toronto: C. D. Howe Institute; Washington, D.C.: National Planning Association, 1991).

Each subregion must decide its priorities: whether subregional integration should come first, or whether accession to NAFTA is more important. Subregional integration is likely to be more important in the long term. If all LAC countries were to join in a WHFTA, the trade preferences of all of them would be diluted. One big FTA in the hemisphere could first deal primarily, perhaps exclusively, with trade. It will be more like the EFTA, a preferential trading arrangement, and less like NAFTA, which involves many other rights and obligations of its members.

Over the long term, subregional agreements other than NAFTA can also deepen beyond trade matters into other economic areas, transportation, and policy consultation. Effective subregionalism does not preclude preferential trade with the countries of North America. If anything, subregional integration will enhance the bargaining power of the subregions.

A good case can be made that NAFTA should not accept individual country applications for free trade.[29] The reasoning is that accepting country-by-country applications would only complicate the maze of integration agreements that already exist, and it would thwart promising movement toward subregional integration in the hemisphere. Implicitly, this meant that Chile should be forced to join a subregional grouping, presumably MERCOSUR before NAFTA would accept a Chilean petition to open FTA negotiations. But Chile is unique in that it is not now a member of any subregional integration arrangement other than LAIA, and moreover it is the only LAC country other than Mexico that is ready to begin negotiations to enter NAFTA.

Some other countries, in addition to Chile, are not now members of subregional groups. These include Panama, Haiti, the Dominican Republic, and Suriname. If Chile were accepted into NAFTA on an individual basis, then why not the others? On a practical level, the answer is that Chile is ready for free trade with NAFTA because of its internal restructuring; the others are not. On a more general level, NAFTA loses its *raison d'être* if every "orphan" country is admitted regardless of its potential economic contribution. These countries should first seek subregional partners before seeking entry into NAFTA, but they should not be penalized as the process plays itself out. Some enjoy trade preferences in the U.S. market under the CBI.

It is clear that the LAC countries have not yet established priorities between subregional integration and accession to NAFTA. Apart from Chile and Mexico, no other LAC country is ready for accession to NAFTA. For countries to open reciprocal negotiations to obtain free access to the United States in the context of an FTA before they open their own markets will not work. One-way preferences into the U.S. market already exist for Andean and CBI countries. Countries should first demonstrate that they are able to open markets within their own subregions. This would strengthen subregional economic and political solidarity in the hemisphere, an advantage that would be lost if each country acts separately to negotiate for accession to NAFTA.

The negotiating group on the North American side presumably would not be the United States acting alone, but NAFTA. The individual countries of NAFTA would have to agree to such a negotiation, just as the individual countries of other subregional groups would have to consent. This assumption raises a number of issues. It is not difficult to state, in principle, that NAFTA is open to accession by new countries; that is in the agreement. In practice, however, a number of problems arise.

29. See Sidney Weintraub, "The New U.S. Initiative Toward Latin America."

Each country of NAFTA, the accession clause states, must go through its constitutional and legislative procedures for accepting a new member, whether a single country or group of countries. Because the new members would be joining NAFTA, the provisions of that agreement would set the parameters for membership.[30] The negotiation, in other words, would not be to alter the basic agreement for the benefit of the applicant country, but rather to discuss the transition to membership. Some applicants will need a long transition with many exceptions during the phase-in period, others will need less time and fewer exceptions.

However, the widening of NAFTA will limit its deepening among core countries ready and able to augment what now exists in the agreement. This is the last point mentioned under the constraints that must be dealt with in the hemispheric integration process. Deepening of integration in North America would not have the same content as it does in the EC. The three countries in North America do not aspire to economic and monetary union, let alone political union. However, they may wish to limit the volatility in their exchange-rate relationships as trade increases. At some point, they may be prepared to consult more frequently on prospective changes in economic policy or in their regulatory framework. It is possible that they can make their dispute-settlement arrangements more comprehensive and more binding than is now the case. This is possible not just in the pure trade area, but in trade-related environmental issues and in complaints about labor standards. This type of deepening among most LAC and North American countries is far more problematic.

Other subregional groupings of LAC countries may wish to pursue their own versions of deepening. The opportunity to accomplish this deepening would be lost if entry into NAFTA proceeds by country by country. There would be no possibility for subregional deepening unless subregional integration were given top priority. Even if the NAFTA countries showed little interest in widening their preferential area—something that is clearly possible with changes in the political situations in all three NAFTA countries—subregional integration would have its own rewards.

There is another option to a single WHFTA that could lead to hemispheric free trade without compromising the potential for deepening the relationships within subregions: a series of free-trade agreements between NAFTA and other subregional groups, or the concentric-circle approach to hemispheric free trade. Under this choice, the NAFTA itself need not be the basis for the negotiation. Instead, two subregional groups with different obligations among their members would seek to reach free trade. This would not obligate either group to accept the other's internal arrangements. It is, in rough form, the model that was followed in Europe between the EC and EFTA. The groupings might eventually come together if developments lead in that direction, but this would not be necessary.

If the FTAs between the subregional groups were only with NAFTA, this would create another form of hub and spoke, with the three countries of NAFTA as the hub. To avoid this, it may be necessary for the various subregional groups to reach free-trade agreements among themselves. The disadvantage of this approach is that it would create a new labyrinth of FTAs, but the structure would be much more straightforward than what now exists. After all, the EC and EFTA have separate provisions, but also free trade between them.

30. This was the preferred choice set forth in Peter Hakim and Nora Lustig, "Western Hemisphere Free Trade: Issues and Prospects: Notes of a Policy Discussion," issued by the Inter-American Dialogue and the Brookings Institution, September 16, 1991.

These two approaches to hemispheric free trade would be likely to lead to different outcomes. The first approach, looking toward a single hemispheric FTA, would subordinate other subregional arrangements in the sense that they would have to abide by NAFTA provisions. Under this scenario, they would become redundant and probably wither away. The second approach would allow each subregion to develop according to its own idiosyncrasies, but still lead to free trade between it and NAFTA, and between it and other subregions. Other subregional groups could seek accession to NAFTA as a group if they preferred this path rather than a separate FTA with NAFTA, but the ultimate decision in this case would rest with NAFTA. A series of concentric circles—a series of FTAs among regional groups—would simplify the labyrinth of integration arrangements that now exists if it were made clear that individual countries could join only one subregional arrangement. If individual countries continued to have multiple subregional memberships, this would complicate the current complexity of trade relationships.

Summary of Approaches to Hemispheric Free Trade

The danger of the hub-and-spoke option, with the United States as the hub country, has been diminished by the trilateral participation in NAFTA. This concern would be eliminated completely if NAFTA were to negotiate as a group with applicant countries or groups of countries.

Still, NAFTA could be the hub, particularly over a transition period as new countries or groups of countries join. This is one option for reaching hemispheric free trade: using NAFTA as the center which receives accession applications from other countries or subregional groups. This would cause increased discrimination against countries outside NAFTA until there was one grand WHFTA.

The advantage of this approach is that it may lead to the creation of a single WHFTA in which all countries are treated equally. Its main disadvantage (other than the inherent growing discrimination over the transition period) is that it would not permit deepening either of NAFTA or other subregional arrangements.

Another approach is to encourage the strengthening of subregional groups of LAC countries. These subregional groups could then seek accession to NAFTA, in which case they would still have to use the provisions of NAFTA as the basis of negotiation; or instead they could seek separate FTAs with NAFTA and with each other.

The advantage of the approach involving a series of FTAs is that it permits deepening of economic integration among like-minded countries without prejudice to the free-trade objective. Its disadvantage is that it maintains (perhaps indefinitely) a large number of subregional groupings.

Institutional Arrangements

Two rules of institution building should be kept in mind. First, do not create institutions in the simple hope that a new body will lead to creative thinking. Second (a corollary of the first), do not create an institution until it is clear what it will administer. The hemisphere is already replete with institutions; adding yet another without a clear objective would most likely intensify turf battles.

There are other viewpoints. One suggestion is that while existing institutions may be able to carry out many research and planning functions for now, consideration should be given to new architecture required to guide an economically integrated hemisphere.[31] The underlying argument of this position is that a new mechanism will be needed to make prenegotiation studies, check new FTAs for cross-consistency, help to settle disputes, and perhaps help in the negotiations a developing WHFTA will require.[32]

Following the second rule—do not create a new institution until it is clear what is being administered—calls for delay of institutional decisions until the sequencing option toward hemispheric free trade is chosen. More precisely, it means using existing hemispheric and subregional institutions for the time being. These include the IDB, ECLAC, the Organization of American States, and the various secretariats of the subregional integration arrangements.

If the architecture chosen for hemispheric free trade is to seek a single WHFTA by building on the core of NAFTA, it will require its own institutional structure. If, instead, the path chosen is that of reaching free trade by a series of FTAs, then quite different institutions are needed. In the first case, the organization would have to be similar to those of other large integration arrangements, a secretariat for monitoring the daily operations of the WHFTA and for carrying out studies and making proposals, a policy- and rule-making body, and panels for dispute resolution and preparation of positions for negotiating purposes within the WHFTA and with other countries and groupings. This is the kind of mechanism suggested by Feinberg and Hakim. Implicitly, they assume option one. The arrangement would be something between that of the EC Commission and the EFTA secretariat—its powers would be less than those of the EC Commission because the WHFTA would have a less ambitious mandate than the EC, but greater than those of the EFTA secretariat because EFTA itself has a less comprehensive agenda than a WHFTA built on the core of NAFTA would have.

If the choice is option two—based on FTAs among subregional groupings—a large, unified secretariat would not be called for. Instead, each subregional group would function with its own secretariat but with coordinating functions among the various groups to ensure consistency among the FTAs. Existing institutions like the OAS, the IDB, and ECLAC could provide comprehensive studies as required.

If priority is given to building subregional integration arrangements, then the choice of the ultimate institution can clearly be delayed until the overall architecture is determined. Subregional integration arrangements can accommodate either option, even though each has different institutional requirements.

One other institutional feature should be mentioned. NAFTA, unlike the EC, does not call for financial transfers from the two wealthy countries to Mexico. The financial transfers that do take place come from outside the NAFTA structure, such as from the IDB. A North American regional

31. Richard E. Feinberg and Peter Hakim, "The Americas Commission: A Proposal," in Feinberg and Hakim, *New Directions in U.S.-Latin American Relations* (Washington, D.C.: Overseas Development Council and Inter-American Dialogue, 1991), pp. 23-28.

32. The series of studies of which this paper is a part being carried out cooperatively by the IDB and ECLAC is presumably an example of what this suggestion has in mind.

development bank was established to help NAFTA members solve infrastructure and adjustment problems in the transition to free trade. Similar suggestions have been made about the need to help the least-developed countries of the hemisphere prepare for free trade.[33] Should there be a special bank for hemispheric economic integration, similar to that in the EC and in some subregions in LAC? Or, can this function be assumed by the IDB augmented by the subregional development banks already in existence? Since the resources of the IDB have been augmented in recent years. It is most unlikely, therefore, that the United States would consent to still another development bank for the hemisphere. The strength of the free-trade proposal is that it provides permanent opportunities, not foreign assistance dependent on the whim of the United States president and Congress.

Concluding Comments

The main purpose of this paper has been to examine paths to hemispheric free trade and explore the institutional implications of the paths. To do this requires analysis of the objective situation in the hemisphere: Why is hemispheric free trade now an option when just a few years ago the idea would have been dismissed out of hand? The answer is in the nature of the development philosophy that has emerged in the LAC region. Countries are opening their markets and seeking to promote exports, with or without free trade. The process of getting to free trade also requires that the countries of the hemisphere decide what they want in the final arrangements. This writer's judgments on these matters were cited as the constraints that must shape the process of movement toward free trade. What follows are considered opinions about the institutional choices to be made and their sequencing.

1. The strengthening of subregional arrangements should receive priority. These groupings can and should be the building blocks of hemispheric free trade. This priority does not require that every LAC country be part of a subregional grouping, since several countries are now outside the main subregional economic integration arrangements and should not be forced against their perceived interests to enter one of them. The main thrust should be toward inclusion, and with the likely exception of Chile, countries that choose to remain outside of groupings in their own subregions should not have the option of joining NAFTA individually. Because most LAC countries, to one degree or another, are now opening their markets, the prospects for trade-expanding subregional integration are more promising than at any time since World War II.

2. Of the two major paths to free trade—building on NAFTA and enlarging it as other subregional groups (or in the case of Chile, that country alone) are ready to seek accession, or concluding a series of FTAs among subregional groupings, including NAFTA—the latter is to be preferred because it will not preclude the deepening of each subregional group, whereas building on NAFTA alone would slow the progress of all groups to the ability of the countries least able to take on greater obligations. Hybrids of these two options are sure to emerge, such as a mixture of some subregional groups

33. See Bernal, "A Caribbean Perspective...."

seeking entry into NAFTA and others more content to maintain their own structures but still wanting free trade with the NAFTA countries.

3. Decisions on the structure are best delayed until the path to free trade is more clearly defined. The two sequencing options have quite different institutional implications.

It is unclear where the free trade proposal will take the countries of the hemisphere. Many intervening circumstances will influence the thinking of countries. Yet a process has started, and negotiations for reducing subregional trade and related barriers are taking place throughout the hemisphere. Unlike the past, these are intended to be trade-expanding. The very idea of hemispheric free trade, unthinkable as recently as a decade ago, is being given serious attention. The process in place is one of opening markets, not closing them. This is new and should be encouraged.

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EVALUATION OF A CHILE-U.S. FREE TRADE AGREEMENT

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Introduction and Overview

The degree of change in the international arena in recent years would have been impossible to predict only a decade ago. While some of these changes have been purely economic and others the result of changes in political systems, all have helped create a new international economic scene. Chile, exposed to the ebb and flow of the global economy, should use these changes to identify and evaluate new economic opportunities and make political decisions in order to reap potential benefits.

Conditions in the 1990s are substantially different from those that existed 15 years ago when Chile's unilateral trade liberalization began. Since then, most Latin American nations have adopted less protectionist measures and generated discussion about the best method of opening to international markets. Among the various liberalization strategies that have been examined are unilateral liberalization, liberalization within a tariff union in which trade policies toward the rest of the world are developed with member nations, and free trade agreements (FTAs), which allow each member to determine its own trade policy. In most cases, the reduction of protectionist measures in Latin American nations has been done unilaterally, with a bilateral strategy to complement trade liberalization.

This new Latin American attitude toward trade policy emerged when Chile embarked on a political transition to democracy. This political change has made it possible for Chile to become part of new integration strategies and attempt to become more closely tied to nearby markets. During the 1980s, the importance of Latin American nations in Chile's trade had decreased as a result of recessions, adjustment, and the debt crisis.

At the same time that Latin American nations began adopting liberalization policies that industrialized nations had been promoting for years, the continued vitality of the world trade system was called into question. The United States, which had previously championed trade liberalization by sponsoring multilateral negotiations, began to feel threatened by international competition. Concurrently, however, bilateral and interregional negotiations emerged as a more efficient alternative for solving trade disagreements by reducing the number of sources of disagreement. This development appears to be leading to the creation of regional economic blocs. It is frequently suggested that the world is already divided into three economic blocs: the European Economic Community (EEC, now the EU), the North American Free Trade Area (NAFTA), and Japan and Southeast Asia.

The most obvious of these three blocs is Europe. The EU, already a customs union, created an economic entity with unified, coordinated policies. The EU will function much like a single federal state. Several European countries that have already signed a free trade agreement with the 12 nations of the EU and those that form part of the European Free Trade Area will join the customs union. Eastern European nations may also join this association.

The integration of the Eastern European countries into the flow of international trade opens new opportunities, but at the same time it closes others. This is especially true of Chile, whose natural resource base is similar to that of some of the Eastern European nations that have the advantage of being close to developed markets.

The context of intense change gives rise to another variable relevant to the development of Chile's trade policies in the 1990s. With the hope of strengthening the favorable attitude toward liberalization now prevalent in Latin America, the United States is proposing the possibility of creating a free trade zone throughout the hemisphere. As time passes, it becomes clearer that this is a long-term goal whose success depends on political events in the U.S. as well as the progress of Latin American nations in political reform. Nevertheless, the possibility that Chile will sign a free trade agreement with the U.S. has become less remote. Former U. S. President Bush was committed to making Chile the first country to sign an FTA once the agreement with Mexico was approved.

As a result of these changes in the international panorama, two options have emerged, and Chile should evaluate them with great care because of their potential benefits. The first is the possibility of signing a free trade agreement with the United States, historically Chile's main trading partner. The second is the possibility of further integration with MERCOSUR. Argentina, Brazil, Uruguay, and Paraguay have already reduced tariffs among members, but the structure of common external tariffs with nonmember nations is not yet certain.

The possibility of signing an FTA with the United States is clearly perceived as a positive move for the Chilean economy. However, such an agreement will not improve access for Chile's exports to the U.S. market since barriers are already quite low. In fact, the average weighted tariff applied to Chilean exports to the U.S. was only 1.8 percent in 1991. Exports were hardly affected by quantitative barriers, and the most serious problems in terms of access were a result of technical barriers. It is worth noting that some of these technical barriers were solved by the bilateral commission that was formed upon the signing of this agreement. It is unlikely that other barriers such as marketing orders for fruit exports will be eliminated in the process of negotiating an FTA.

It is, therefore, necessary to elaborate on the enthusiasm that an FTA with the United States has caused in Chile. There are numerous reasons for this, some of which relate directly to trade and others that are less tangible but whose benefits could be greater than traditional results.

The average tariff imposed on Chilean exports is minimal and reflects of the fact that Chile is an exporter of natural resources that undergo very little processing. These goods are poorly protected by the American tariff. In certain sectors there is a strong tariff schedule designed to protect domestic industry in the United States, and Chilean products face tariffs of 35 percent or higher (Butelmann and Campero 1992).

As long as Chile continues on the path of export diversification (which has been extremely successful in recent years [Campero and Escobar 1992]), tariff scheduling will remain a significant obstacle. Thus it is important to negotiate the reduction and eventual elimination of the highest tariffs, not only to achieve greater access to that market, but also as a fundamentally defensive measure. In many products Mexico and Canada are Chile's most important competitors in the U.S. market: it is preferable to compete under the same conditions. Since Mexico and Canada will both be able to export their products to that market without tariffs, Chile should seek to achieve the same status.

To analyze the benefits of an FTA with the United States or with NAFTA, it is not sufficient to consider only those obstacles facing Chile in the present. It is also important to consider the issue of stability with respect to rules of access. Once imports reach a high rate of growth, pressures emerge in the importing country to increase access barriers. Recent U.S. trade deficits have increased the propensity of U.S. authorities to accede to such pressures, and the perception of a loss of hegemony in world economic leadership has also played an important role. There has been an increase in tariffs to compensate for subsidies and disloyal pricing policies on the part of exporters, and other less transparent measures in the guise of imposing "voluntary export restrictions" on countries that have followed a successful path in the promotion of exports.

The apparent movement toward the creation of a series of economic blocs and the possibility that the General Agreement on Trade and Tariffs (GATT) will be weakened if the Uruguay Round does not fulfill initial expectations make it important to ensure that the rules of the game are not changed for Chile, at least in the United States, which is one of Chile's main trading partners and the only developed nation that is offering us the possibility of an FTA.

Beyond its direct or potential benefits in the flow in trade, an FTA is important in and of itself. Despite the fact that Chile has already negotiated and signed an FTA with Mexico, an agreement with the United States brings something that no agreement with Latin American nations can: an FTA with the U.S. will include a much wider range of areas than would otherwise be included in a similar agreement with some other country, and the requirements for transparency and predictability with respect to the rules of the game will be much more demanding. In fact, the terms required by the U.S. even to begin negotiations are *a priori* stricter than those of less-developed countries. All of these demands—which in some cases will be costly to comply with, such as environmental measures—will provide Chile with a seal of approval that will enhance chances for capturing foreign investment. That is quite important at a time when there is tremendous competition between Latin American nations (and developing nations in general) for foreign investment.

The United States has emphasized the fact that Chile would be the only Latin American nation able to negotiate an FTA. This contributes positively to Chile's image, but at the same time may mean a postponement of the most important global benefits of a WHFTA. This potential market would assure Chile free entry into the markets of neighboring nations. There is tremendous potential for growth and a better opportunity for exporting industrial goods as well as further diversification of export products (Saez 1992).

If a WHFTA seems too remote a possibility, then Chile should examine alternative methods for expanding exports into those markets. One realistic possibility would be Chile's incorporation into MERCOSUR. However, Chilean authorities have been hesitant about such a move for a variety of reasons, the most important of which is the macroeconomic instability of the MERCOSUR nations. The current Chilean tariff of 11 percent, and the barriers to Argentine and Brazilian trade are not sufficient to protect Chile from the instability with regard to real change possible within these nations. Greater integration of trade would increase MERCOSUR's importance in the volume of Chile's trade and make Chile more vulnerable to instability. The macroeconomic instability of Argentina and Brazil causes major fluctuations in the type of real exchange between Chile and those nations, alters the balance of trade, and diminishes the incentives of domestic producers.

The issue of macroeconomic instability is a negative element of integration; however, it can also be a positive factor. If macroeconomic instability may eventually reverse the liberalization of these nations, it is better to assure entry into those markets through some trade agreement.

Another factor that contributes to a rejection of the idea of becoming a part of this future common market has to do with the determination of the common external tariff. The countries of MERCOSUR have not been able to agree on the structure of this tariff, but today it seems quite clear that it will be staggering and that the highest percentage will be more than the 11 percent maintained by Chile. In the 1970s, Chile suffered the effects of a profound structural change when it opened itself up to international markets. Beyond the efficiency of a single tariff rate, there would exist no desire to face another radical change in relative prices and long-term incentives.

Despite the disadvantages of membership in MERCOSUR, the enormous potential of these markets should not be underestimated. These countries represent the principal destinations of Chilean exports to Latin America, and despite recent liberalization they still provide greater levels of protection than the United States. Gains made in access would be stronger, and possibilities for future recuperation are many.

Beyond gains in trade, the MERCOSUR alternative could accelerate the flow of foreign investment. It is not enough for Chile to be economically efficient with an infrastructure superior to that of her neighbors. The existence of a market for the products of companies that establish themselves within Chile is absolutely essential. It is clear that, if in addition to being able to meet the needs of a small internal market, Chile is also able to assure companies access to a market as important as Argentina's or Brazil's, then interest in Chile will be even greater. The goal of attracting foreign investment with the incentive of covering larger markets is more difficult to achieve with an FTA with the United States because investments will go to Mexico, which has geographic advantages, in addition to being the first Latin American country to be a member of NAFTA.

Finally, given the close proximity to those markets, especially Argentina, integration would allow for a greater possibility to increase productivity and competition in foreign markets and an increase in intraindustry trade. Intraindustry trade makes structural adjustments caused by an FTA less traumatic compared with cases in which the increase in intraindustry trade provokes the disappearance of certain subsectors of the economy, where capital and capabilities specific to it are lost.

It is important to design frameworks that allow Chile to take advantage of the benefits of the Argentine and Brazilian markets, but at the same time minimize the costs mentioned above. The central issue is obtaining preferential access to this market without having to adopt the common tariff agreed to by member nations. This is not a new problem. In other cases, it has been resolved through the signing of an FTA with the tariff union or common market. This occurs among nations that belong to the European Free Trade Area and the EU, and it is what will happen if MERCOSUR signs an FTA with the United States. It is, however, uncertain if the countries of MERCOSUR would be interested in this option. Argentina's interest in having Chile become a member of MERCOSUR is due in part to its interest in having more leverage in negotiating the external common tariff, given their differences with Brazil, which is pushing for a higher tariff. On the other hand, if MERCOSUR decided to set a uniform common tariff close to 11 percent, should Chile become an active member of MERCOSUR? This question merits careful examination.

This study analyzes some of those issues in the debate over the advantages and disadvantages of an FTA with the United States, as well as alternative trade strategies available to Chile. The first section lists the direct and indirect costs and benefits of an FTA with the U.S., and how these are perceived from a Chilean perspective. The second section presents a detailed analysis of the evolution of the various categories of Chilean exports (natural resources, processed natural resources, and other industrial products) into different types of markets. The paper then identifies those industries that could benefit from an FTA with the U.S. The third section analyzes the tariff scheduling which affects Chilean exports of processed natural resources and identifies the areas in which the elimination of tariff scheduling would create incentives to increase exports. The fourth section presents a quantitative analysis of the direct effects of an FTA with the U.S. The environment and the various arguments that link it to international trade are the subject of the fifth section. Finally, the sixth section analyzes Chile's position vis-à-vis MERCOSUR.

The Initiative From a Chilean Perspective

The least important benefit of an FTA with the United States would be increased access for Chilean exports to the U.S. In 1991, tariff barriers reached an average of 1.8 percent, and while a clear tariff scheduling exists, a large part of this was eliminated by Chile's reintegration into the Generalized System of Preferences (GSP) (see the section on Chile's export structure).

The great enthusiasm that the possibility of an FTA with the U.S. has generated among Chilean authorities is not based on tangible benefits, even though these are thought to be more significant than mere reduction of tariffs for current exports. It is important to remember that the Chilean export basket diversifies rapidly, and barriers that are not of concern today could limit export growth in the near future (see the section on Chile's export structure).

Stability in the rules of access is critical in the process of export diversification because diversification requires high levels of investment. Chilean producers must have safeguards against export barriers, and they need direct channels for resolving conflicts. This is important, given the fact that when an exporter achieves success in that market, protectionist pressures emerge as a result.

One way Chile can defend itself from the privileged access of its main competitors is another benefit that will emerge as Chile begins to export goods that have higher levels of protection. Chile's most important competitors for the U.S. market for a large percentage of such exports are Canada and Mexico. Given their unrestricted access to this vast market because of geographic proximity, it is important for Chile to obtain similar conditions with respect to protectionist barriers.

Finally, and perhaps most important, the signing of an agreement of this nature would help Chile's image as an attractive country for investment. At a time when many countries in the region are implementing economic reforms, it is important for Chile to distinguish itself as a stable, modern nation where foreign investors will find guarantees for their investments.

Still, a price must also be paid for such benefits. One result is trade diversion, the traditional cost of an FTA. U.S. participation in Chile's foreign trade has been decreasing and was less than 18 percent in 1991. Therefore the possibility of diversion is significant even if the level of protection in Chile is low. Chile's 11 percent tariff is uniform. However, the reductions in duty foreseen in an

FTA is gradual, and it is probable that Chile will continue to reduce its tariff to the rest of the world in the future. As the preferential tariff for the United States—as well as the general one—is reduced, the costs of trade diversion are also reduced. The cost would be further reduced once other countries in the region become part of a regional FTA.

Chile has already implemented a series of economic reforms that have liberalized internal markets and foreign trade. Significant progress has also been made with respect to international commitments. As a result of these reforms, there exists—in both Chile and the United States—the perception that the negotiation of an FTA would be relatively quick. There are issues that will not be that easy to negotiate, and changes must take place in Chile in the areas of foreign trade as well as with respect to domestic laws and institutions. The possible sources of conflict that as a minimum require changes in the way they currently operate are tarriffs, subsidies, government purchases, safeguards, compensatory tarriffs and antidumping, investment, intellectual property rights, and the environment.

Tariffs

Certain agricultural products enjoy levels of protection greater than 11 percent, as well as other variables in existence for agricultural products. Prices of wheat, oleaginous products, oil, and sugar are protected from the fluctuations of international prices. Other agricultural products, such as rice and flour, are protected by temporary surtaxes. It is obvious that upon negotiating an FTA, the United States will push for the elimination of these barriers. Plans are in place for agricultural reconversion to assist in the substitution of more profitable crops, and it is possible that a gradual duty reduction will provide adequate time to soften the impact. There is tremendous opposition on the part of powerful interests to the plans to reduce protection of the agricultural sector. These interests will put forth strong opposition to any trade agreements with nations that export these same crops.

Duty Drawbacks

Another controversial subject in the area of altering relative prices is that of drawbacks. Chile has two drawback systems. The first, known as *simplified drawback*, applied to low-cost, nontraditional exports is canceled out as a percentage of the export value, and not in relation to utilized import consumption. In several cases, this translates into a subsidy for exports and, as a result, is a potentially controversial topic in trade negotiations.

Government Purchases

Chile would not have to make great changes in this area because in practice its public acquisitions are guided by the principle of minimization of costs rather than protecting domestic industry. Nevertheless, this principle should be explicitly incorporated into legislation, and precedent should be set for arguing discrimination cases in the adjudication of public contracts. The signing and implementation of GATT's Governmental Purchase Code would constitute an important step toward stability and transparency in the adjudication of this sector.

Safeguard Mechanisms

If an FTA between Chile and the United States is signed, it is more likely that Chile would use emergency protection measures in the case of abrupt increases in the imports of a product that could damage domestic industry. In order to do that, Chile would have to pass a safeguarding law. Currently, changes in tariff rates must be approved by Congress except those required to protect from distortions in international prices that harm national products.

Compensatory Tariffs and Antidumping

One of the main arguments in favor of negotiating an FTA with the United States is to protect Chile from frequent compensatory and antidumping measures which the U.S. often applies. However, to date no country has gotten the U.S. to modify such legislation. The most important progress that has been made is that these decisions can now be appealed before a bilateral panel. In this way, the appeal process is impartially expedited.

Legislation in Chile does not differentiate between dumping and subsidies, and the processes for determining the imposition of a tariff to protect disloyal competition are not transparent enough. Thus, if it is hoped that a binational panel will be established to ensure that compensatory measures adjust to the laws of the nation imposing them, it will be necessary to make some changes in Chilean laws.

Investment

The system that regulates foreign investment in Chile is among the most liberal and least discriminatory. Nevertheless, terms that have to do with the procedural transparency of investment approvals and time frames for the repatriation of invested capital need modification. Currently the Committee on Foreign Investments has the power to reject foreign investment programs. This power has not yet been used, but it will still be necessary to regulate its use as well as the time limit within which it can be used. On the other hand, at the time of writing, laws do not allow for the repatriation of capital until three years following the actual investment. Both of these issues are currently being modified in favor of foreign investment.

Intellectual Property Rights

During an FTA negotiation, Chile will clearly be pressured to modify its law regarding intellectual property rights, especially in relation to pharmaceutical patents. Chile recently adopted a new law on intellectual property rights, but this law was not satisfactory to the U.S. because it contains no pipeline mechanism and a shorter period of protection for patents than the U.S. originally wanted.

Environment

Chile will have to make changes in its environmental laws. Although there will be long-term benefits, initially such changes will require large public and private expenditures.

The direct benefits of an FTA will not be terribly important in the short term, but its adoption will protect Chile for the future and consolidate its image. The FTA would require Chile to adopt costly reforms, but these reforms would have to be implemented sooner or later in order to maintain Chile's presence on the international scene. Hence, these costs are not seen as directly attributable to the FTA with the United States.

Structure of Chile's Exports

Export structure reveals the nature of a nation's comparative advantages. In order to examine Chile's export structure, two different aspects will be considered: (1) Export classification into three categories, natural resources (NR), industrial goods derived from processed natural resources (PNR), and other industrial products (OIP); and (2) four destination markets—the U.S., the EU (European Union, formerly the EEC), Japan, and LA (Latin America).

Most of Chile's exports to developed nations are NR; in 1991, it is estimated that NR represent over 61 percent of total exports to the U.S. and Japan, and almost 70 percent of those to the then EEC (see Table 1). PNR make up the second most important category in Chilean exports to developed countries, roughly 30 percent of total exports to each market. Finally, OIP comprise slightly more than 10 percent of exports to the United States, less than 5 percent to the EU and less than 1 percent to Japan. On the other hand, in 1991, Chilean exports were equally divided among the three categories of goods in the Latin American market: NR, 35 percent; NPR, 38 percent; and OIP, 27 percent (Table 2).

Table 1
Composition of Chilean Exports by
Market Destination, 1991
(percent of total)

Sector	U.S.	EEC	Japan	ALADI
Natural resources (NR)	61.2	69.1	62.3	34.7
Processed natural resources (PNR)[a]	28.7	26.3	36.4	38.0
Other industrial products (OIP)	10.1	4.6	1.3	27.3
Total	100.0	100.0	100.0	100.0
Value of exports ($ million)	1,596	2,881	1,644	1,239

a. There is a correlation between categories NR and PNR, i.e., industrial goods included in PNR require a higher degree of processing than goods in the NR category.

Source: Campero and Escobar (1992)

Given the different volumes of exports to these four regions, it is useful to examine the relative significance of each region in the two categories of Chilean industrial exports in 1991 (Table 2). The EU and Japan received 26.6 percent and 21 percent, respectively, of total exports in the category

Table 2
Sectoral Distribution of Chilean Exports
According to Market of Destination, 1991
(percent)

Sector	U.S.	EEC	Japan	ALADI	Remainder	Total	Total ($ mill)
Natural resources							
Mining[a]	9.7	38.5	24.5	8.5	18.8	100.0	4,037
Fruits & veg.	48.2	35.7	0.7	7.2	8.3	100.0	1,081
Game	8.5	49.9	1.1	30.0	10.5	100.0	22
Fishing	57.3	31.8	8.4	0.8	1.7	100.0	111
Forestry	0.7	6.3	30.1	1.3	61.6	100.0	67
Subtotal	18.4	37.4	19.3	8.1	16.8	100.0	5,319
Processed Natural Resources							
Mining	39.9	31.4	6.2	13.2	10.0	100.0	451
Horticultural	25.6	16.9	9.3	33.3	15.0	100.0	505
Game	0.1	17.1	19.7	51.8	11.3	100.0	43
Fishing	8.5	34.7	25.4	2.4	29.0	100.0	977
Forestry	8.0	21.0	30.5	22.5	18.0	100.0	872
Subtotal	16.1	26.6	21.0	16.5	19.9	100.0	2,849
Other Industrial Products							
Chemical products	15.5	18.0	4.2	29.0	33.2	100.0	507
Textiles	35.5	14.4	0.1	40.9	9.0	100.0	148
Metal-mechanics	11.3	10.3	0.1	68.7	9.6	100.0	181
Others	20.2	5.3	0.1	12.5	61.9	100.0	45
Subtotal	18.2	15.2	2.5	38.3	25.8	100.0	881
Totals	18.2	31.8	18.2	13.7	18.7	100.0	9,049

a. Includes refined copper.

Source: Campero and Escobar (1992).

of PNR; the United States and Latin America receive approximately 16 percent each. In the case of OIP exports, Latin America stands out, receiving 38.3 percent of total exports; the EU and the U.S. received 18.2 percent and 15.2 percent, respectively, of OIP exports, and Japan received only 2.5 percent.

There is a certain global similarity in the structure of Chilean exports to developed nations: NR and PNR make up over 90 percent of exports to those markets. But there are differences in the types of NR and PNR exported to each of these markets (Table 2). With regard to mining NR, the EU and Japan are the largest markets, while the U.S. and the EU are the main destination markets for mining PNR. With regard to fish, fruits, and vegetables (NR), the U.S. and the EU are the main markets. Japan and the EU are the principal markets for forestry and fish PNR.

When comparing the evolution of Chilean exports to developed countries during the period 1986-91, Campero and Escobar (1992) observe a negative correlation between sectoral NR exports and the equivalent industrial PNR goods according to specific destination markets. For example, in the case of the United States between 1986 and 1991, Chile's forestry exports fell while there was a significant simultaneous increase in PNR forestry exports. A similar pattern occurred in the areas of fish and fishing NR. This suggests that there is substitution of NR exports with the corresponding PNR in the same destination market. We could be seeing the spontaneous induction of the process of increasing the value added to exported NR.

Chilean OIP export statistics for 1991 show that Latin America is the most important market for metal-mechanic products and textiles. The United States has also acquired an increased importance in the area of textile imports (Table 2.2).

We can draw these conclusions from this analysis of Chile's export structure: Chile's comparative advantages with respect to developed nations are in the category of NR. The increase in industrial goods exports to these markets appears to be oriented toward the expansion of the respective PNRs that correspond to the NR currently exported to each market. In the Latin American market, Chile has comparative advantages (in addition to traditional NR) in PNR and certain OIP (metal-mechanics, textiles, chemicals). The case of textile exports illustrates the possibility of Chilean exports to the U.S. (and Latin America) that are not based on the highest existing level of processing of NR in the country.

The Chile-U.S. FTA and Potential Exports to the U.S.

The following procedure has been used[1] to evaluate the effect that an FTA between Chile and the United States would have on potential Chilean exports to that market. At the product level, we have examined Chilean industrial exports whose market destinations are developed nations. Then we selected those goods in which the U.S. is overrepresented in or absent from Chile's exports in relation to the EU and Japan.[2] For this category of goods, we have analyzed whether a demand for imports exists in the U.S., and the principal supplier countries where it does exist was identified. An implicit assumption is that Chilean industrial goods currently exported to other developed nations, the EU, and Japan will

1. This section is based on Campero and Escobar (1992).

2. Only goods in which Chilean exports to the EEC and Japan together surpassed $2 million in 1991 are included. This category of goods surpassed 90% of the total in these markets.

comply with quality standards required in the U.S., but this might not be the case for industrial goods exported to Latin America. Another implicit assumption is that Chile has the productive capacity to supply a greater external demand.

According to this procedure, there are 23 Chilean export products with a potential for expansion in the event of an FTA with the United States. (Table 3). Of these 23 exports, 15 are in the category of PNR, six are NR, and two are OIP. Among the PNR, six are fishing products (fish flour, fish, and canned seafood), five are forestry products (wood, wood pulp, and paper), and three are fruit and vegetable products. In the NR category, we find manufactured copper products, iron pellets, apples, and kiwi fruit. The OIP category includes metal-mechanical products.

It is interesting to observe that Canada is one of the main suppliers to the U.S. market of 15 of the 23 products mentioned, especially forestry and fishing PNR (Table 3). Among Latin American nations, Mexico and Peru stand out as the principal providers of those Chilean products with growth potential in the U.S. market. Even if Chile eventually becomes a member of NAFTA, a significant portion of Chilean exports with the greatest growth potential in the U.S. market will face difficult competition from Canadian and Mexican suppliers already well established in that market.

Tariff Scheduling for Chilean Exports to the United States

Despite significant diversification of its exports, Chile continues to export primarily natural resources or derivatives with a low level of processing. This phenomenon is the result of natural comparative advantages, previous import substitution policies, scarcity of capital for industrial investment, and the distance to the principal export markets. Some of these factors are difficult to change. Tariff policies in principal export markets discriminate against imported processed goods in order to protect local industry. That tariff structure makes the export of processed goods to developing nations difficult (Yeats 1987).

This subject is of great importance in Chile, given its efforts to increase the level of value added to natural resource exports. As developing countries abandon their internal growth strategies and apply liberal international trade policies, more diversified export baskets will emerge and the subject of tariff scheduling and other nontraditional export barriers will take on added importance.

It is important to note which sectors are most harmed by the current tariff structure given the potential for an initiation of discussions of an FTA between Chile and the United States. This information will be useful during negotiations and will also allow for the possibility of foreseeing which sectors will most benefit from tariff reduction. A review of the figures on Chilean exports to the United States during 1990, show that 80.5 percent of exports are concentrated in tariff levels below 3 percent, and half are exempt from customs taxes. To calculate tariffs that fall under GSP status (which was not in place for Chile in 1990), it was assumed that exports for 1990 would have maintained the same structure under this new arrangement. In this way, the percentage of exports which fall under the GSP status that face tariff rates below 3 percent increases to 86.2 percent, and 51.2 percent tax-exempt (Table 4).

Table 3
Chilean Exports of Selected Products and
Principal Suppliers to the U.S

Sector	Description of Tariff Explanation	Chilean Exports Accd. to Destination (thousands of U.S. $)		Principal Suppliers to the U.S., EU, & Japan
Mining NR	Copper minerals and conc.	8.3	480,203.5	Mexico, Portugal
Mining NR	Other refined coppers	18,518.1	197,534.0	Chile, Canada
Mining NR	Iron mineral pellets	0.0	86,337.8	Canada, Brazil, Venezuela
Mining NR	Copper bars for wire	0.0	53,723.4	Peru
Mining PNR	Gold dust (non-monet. use)	0.0	37,351.0	Canada, Guyana, East Germany
Fruit & Veg. NR	Fresh apples	20,899.9	108,234.4	Canada, Chile, New Zealand
Fruit & Veg. NR	Fresh kiwi	3,366.4	40,676.5	New Zealand,
Fruit & Veg.PNR	Sugar Beet	0.0	13,620.4	Canada, Mexico
Fruit & Veg.PNR	Prunes	0.4	3,558.1	China, Turkey, Singapore
Fruit & Veg.PNR	Canned cherries	84.8	2,865.9	Italy, France
Fishing PNR	Fish meal	8,430.5	233,430.9	Peru, Canada, Chile
Fishing PNR	Frozen hake fillets	44.9	69,658.4	Peru, Argentina, Uruguay
Fishing PNR	Frozen Pacific salmon	3.5	65,552.5	Canada, Chile
Fishing PNR	Frozen trout fillets	220.1	21,859.4	Chile, Canada, Denmark
Fishing PNR	Canned clams	11.6	13,068.7	Thailand, Chile, Malaysia
Fishing PNR	Canned razor clams	79.7	6,561.4	Mexico, Peru, Chile
Forestry PNR	Non-pine wood sheets	0.0	134,841.0	Canada, Haiti, Jamaica
Forestry PNR	Semi-blanched wood pulp	567.9	121,478.4	Canada, Brazil, Portugal
Forestry PNR	Serrated pine	5,716.4	74,220.1	Canada, Chile, Mexico
Forestry PNR	Pine Wood sheets	0.0	15,710.8	Canada, East Germany
Forestry PNR	Reams printed paper	0.0	2,891.2	Canada, Switz., Finland
Metalmec. Ind.	Gear shifts	0.0	6,213.3	Canada, Japan, France
Metalmec. Ind.	Cargo ships	0.0	2,650.0	Holland, Canada

NR: Unprocessed Natural Resources
NPR: Processed Natural Resources

Source: U.S. Department of Commerce, Bureau of the Census; Export Shipments, Central Bank. See Campero and Escobar (1992)

Table 4
Distribution of U.S. Tariffs on Chilean Exports

Tariff	Value (US$ millions)	Percent	NMF Value (US$ million)	SGP
0 percent	471.0	40.2 percent	600.7	51.2 percent
0.01 percent - 3 percent	472.9	40.3 percent	410.2	35.0 percent
3.01 percent - 5 percent	54.6	4.7 percent	29.2	2.5 percent
5.01 percent - 8 percent	35.0	3.0 percent	38.4	3.3 percent
8.01 percent - 10 percent	31.6	2.7 percent	29.9	2.6 percent
10.01 percent - 15 percent'	45.2	3.9 percent	38.4	3.3 percent
15.01 percent - 20 percent	48.6	4.1 percent	43.1	3.7 percent
20.01 percent - 30 percent	9.0	0.4 percent	8.6	0.7 percent
30.01 - and over	4.5	0.4 percent	4.5	0.4 percent
Total	1,172,4	100.0 percent	1,172.4	100.0 percent

Source: Butelmann and Campero (1991).

Tariff barriers are few, and their elimination should not have a significant effect on export volume. However, the existence of an important degree of dispersion suggests that potential benefits in terms of access to specific markets can be expected. The following section will show that this dispersion is not accidental, and the highest tariffs are concentrated on the most elaborate manufactured products.

Since we seek to study the effects of a tariff scheduling on the part of the United States toward Chilean exports, this report will concentrate on Chile's main exportable natural resources and will evaluate tariff barriers that make the export of these products—in their various levels of processing—difficult. The sectors chosen for this evaluation are agriculture, fishing, forestry, and copper.

Table 5 shows the degree of tariff scheduling that affects Chilean exports to the United States. Although tariff scheduling exists in all four sectors of importance to the Chilean economy, in most cases this effect disappears when the GSP tariff is considered. Unfortunately, tariff schedules continue in the sector that is our principal export source: fruits and vegetables.

Table 5
Tariff Schedule for Chilean Exports
to the United States, 1990

SA Classification	Tariff NMF	GSP	Percent of total exports
AGRICULTURE			
Vegetables			
Fresh	9.5	6.4	0.52
Dehydrated	5.5	0.8	0.76
Frozen	17.5	14.4	0.03
Canned	13.8	13.6	2.26
Fruits			
Fresh	0.9	0.9	29.66
Dehydrated	2.0	1.9	0.53
Frozen	9.9	4.7	0.20
Canned	7.1	6.9	1.80
FISHING			
Fish			
Fresh	0.02	0.00	5.79
Frozen	0.01	0.00	2.62
Smoked	4.47	4.47	0.07
Canned	5.90	0.01	0.52
FORESTRY			
Wood			
Raw wood	0.00	0.00	1.56
Wood molding & briquette	1.48	0.00	0.48
Wood products	6.80	0.00	0.27
Wood furniture	3.20	0.00	0.68
Wood Pulp			
Wood pulp	0.00	0.00	0.58
Paper	4.80	0.00	0.04
COPPER			
Refined and unrefined	1.00	1.00	15.63
Copp. alloy,bars,wire & plates	1.20	0.00	1.57
Copper products	3.60	0.00	0.02

Source: Butelmann and Campero (1992)

The figures in Table 5 represent weighted averages and therefore do not reflect the level of tariff scheduling for products with little or no representation. Tables 4 and 5 show the tariff for processed and unprocessed resources for a select number of products from the agricultural and fishing sectors, respectively. The tariffs listed correspond to the GSP. For a select group of products, the adjustment to the value added is higher than the average for that particular sector. Indeed, it is essential to make a product-by-product analysis to foresee the effects of a trade liberalization.

To summarize, this analysis of U.S. tariffs and their effect on the principal sectors of Chilean natural resources demonstrates that Chile's exports to the United States are burdened by tariffs that are, on average, low but greatly dispersed. It is important to study these tariff schedules individually to determine Chile's priorities in negotiating lower tariffs.

In the main categories of Chilean natural resources—agriculture, fishing, forestry and copper—the tendency of U.S. tariff schedules to affect higher value-added goods adversely is clear. Nevertheless, schedule levels differ according to each category. The greatest level of scheduling is in agriculture, where tariffs range between 0 percent and 35 percent and are highly correlated to the value added of each product. In addition, the tariff scheduling in this category was not reduced with the introduction of the GSP, and became even worse in the case of vegetables since the GSP primarily benefits fresh products. In the other three categories, the tariff is minor and was either reduced or completely eliminated by the introduction of the GSP.

Quantitative Analysis of the Effect of an FTA Between Chile and the United States

This section first summarizes theoretical a analysis of the effects of an FTA and then presents empirical evaluation of an FTA between Chile and the United States.

Theoretical Elements

The conventional literature on preferential trade agreements highlights two distinct phenomena:[3] the creation of trade and the diversion of trade. Trade-creation is associated with the growth of imports caused by tariff reductions. An analysis of this phenomenon is equivalent to that of a unilateral tariff liberalization. Prior to signing a trade agreement, a country has a tariff *"t"* assigned to a particular product. The establishment of an FTA causes a tariff reduction, i.e., tariff *"t"* is eventually reduced to zero. This creates a new and higher level of consumption, and local production of that product is able to supply only a small part of that demand. The new excess in demand is eliminated through a higher level of imports.

To analyze gains in welfare generated by the phenomenon of trade creation, only net gains in welfare need be considered. In fact, within the local country, tariff reduction causes internal redistribution of welfare. (Extra) utilities caused by tariff *"t"* on domestic products are transferred to local consumers. Likewise, the collection of taxes generated by tariffs paid for imports are not paid when $t = 0$, which is a redistribution from the government to consumers. Net earnings in welfare generated by the creation of trade (which are in turn caused by a reduction in tariffs) are associated with the additional net welfare gain that consumers will receive as a result of the expansion in the consumption of the good in question, as well as the net earnings in welfare generated by the alternative use given the production elements that are freed up or displaced as a result of trade liberalization.

Trade diversion occurs when a product that was imported from country C, is imported from country B after the establishment of an FTA with country B. The tariff benefit given to country B allows

3. *See* Ffrench-Davis (1985); Caves, Frenkel, and Jones (1990)

imports from country B to substitute imports from country C. If D_m is the demand for imports of product k from a given country, which faces a tariff of t_o; at the price $P^*_c\ (1+t_o)$, country C is the one with competitive advantage to supply the local country with the required level of imports. Once a preferential agreement is established with country B, whereby, country B can supply the local country without canceling the tariff previously paid by imports from country C, then there is a possible expansion in the level of imports. These are now completely supplied by country B at the price of P^*_B (this is higher than the price without a tariff P^*_c which country C could supply).

Trade-diversion causes a net increase in welfare for consumers through a reduction of preferential tariffs given to country B; there is a transfer of earnings corresponding to the taxes previously captured by the government, which are now transferred to consumers. On the other hand, there is a net loss of welfare in the local country as a result of trade-diversion; this loss corresponds to a portion of taxes collected prior to the establishment of an FTA.

Once an FTA is established, local consumers pay the price differential (P^*_B - P^*_C) to producers from country B, which are relatively less inefficient than those of country C. If the loss associated with the decreased tax collection is not transferred to local consumers, then it is greater than the increase in the welfare of consumers derived from the marginal expansion of imports, and the phenomenon of trade-diversion causes a net loss of welfare in the local country.

Another important phenomenon to consider is related to the expansion of exports caused by an FTA in the local country. Here it is assumed that the local country is small (Chile) and the other country is large (the United States); the prices of the large country will not be altered by the changes caused in the small country by the FTA. As a result, variations in exports will depend on the price elasticity of the exports. In this case, since the small country will receive preferential tariff treatment, exporters from the small country will receive a higher price for their goods than they received prior to the signing of the FTA. In summary: the price of exports will increase with the establishment of an FTA, and this will lead exporters to increase their level of exports.

As a result, from the perspective of the increase in welfare generated by exports to the FTA, there are two different issues to consider: the price increase perceived by exporters with regard to exports conducted prior to the FTA, and the additional growth in exports.

Empirical Application[4]

To calculate the effects of an FTA on Chilean imports and exports related to the United States, it is necessary to know the price elasticity of the demand for imports and the supply of exports at a particular level (in this case, 3 digits from the Standard Industrial Trade Class, SITC). Because econometric estimates at that level of separation are not available for Chile, the price elasticity of current imports for the Mexican economy are used (INFORUM, 1991); the magnitude of these elasticities fluctuates between -0.5 to -2.0. In the case of exports, De Gregorio's (1984) study has been used for the most aggregated sectors of Chilean exports. The mode value for these elasticities is 2.3 for most

4. For a more detailed discussion of the empirical process and corresponding calculations, *see* Valdes (1992). For the assumptions used in the operationalization of calculating the effect of trade-diversion and the expansion of exports, *see* the Technical Appendix.

categories. For the elasticity of substitution between goods imported from different countries the value of 1.5 has been used.[5]

Imports

Table 6 shows the value of Chilean imports to a level of three SITC digits with a breakdown of its origin according to destination to the U.S. and the rest of the world. This permits a separate calculation of the effects of creation and diversion of trade using a uniform tariff rate of 11 percent as a base. In addition, the value of Chilean exports to the United States are provided, as well as average tariffs these exports paid during 1990.

Table 7 shows the welfare effect associated with trade-diversion caused by the immediate duty reduction to a 0 percent level on imports from the United States. This nonaggregate calculation allows for identification of those national sectors that will face greater competition from the expansion of North American imports. In addition, it shows the sectors where the effect of (negative) welfare due to the trade diversion will reach higher values at the sectoral level than those corresponding to the (positive) welfare effect caused of trade creation.

The total creation of trade of an FTA reaches $223.2 million, equivalent to 16 percent of Chilean imports from the United States (1990). The creation of trade would be concentrated in of nonelectrical machinery ($84.3 million), chemical substances and products ($32.1 million), electrical machinery and parts ($31.6 million), and transportation materials ($18.8 million). Trade-diversion, on the other hand, would reach $152.7 million. The sectors that would experience the greatest level of diversion would be nonelectrical machinery ($45.3 million), chemical products and substances ($28.0 million), electrical machinery and parts/equipment ($18.6 million) and transportation materials ($14.8 million, Table 6).

The effects of the increase in imports on welfare are upset by a profit resulting from the creation of trade valued ($12.3 million) and a loss caused by the diversion of trade valued ($16.8 million) means that if we were to assume a 10 percent rate of discount per year, and if tariffs were lowered to 0 percent immediately, the FTA would mean a loss of welfare in the area of imports valued at $45 million. The sectors most affected by this loss of welfare would be chemical products and substances, and transportation equipment.

To reduce the negative effect on welfare caused by the diversion of trade that resulted from the abrupt reduction in duty on imports from the United States to zero, the authors have examined what would happen if tariffs were gradually lowered over the course of five years. In operative terms, they have assumed that the 1992 rate of 11 percent would be reduced to 8 percent during the first year, 6 percent during the second year, 4 percent the third, 2 percent in the fourth, and zero in the fifth years.

5. For a breakdown by sector and a discussion of value of elasticities, *see* Valdes (1992).

Table 6
Chilean Imports and Exports and
North American Tariffs, 1990

Sector	Chilean imports according to origin ($'000)		Chilean exports to the U.S. ($'000)	Tariff on Chilean exports to U.S. (%)
	United States	Rest of World		
Agri. and Fish	23,079	55,469	378,078	1.07
Mining (Copper & Iron)	5	43	433,514	1.00
Gas & Petroleum	0	818,289	0	0.00
Coal	19,494	74.435	0	0.00
Other minerals/rocks	6,235	22,253	149,760	0.07
Food, Bev. & Tobacco	16.377	243.327	223.116	3.85
Textiles	38.807	222,401	11.702	20.15
Apparel	7.467	30,858	26,047	17.39
Leather and Shoes	2,081	18,254	17,803	8.97
Wood (not inc. furn)	6,988	10,267	30,971	0.95
Furniture (exc. metal.)	1,790	6,085	11,719	3.25
Paper	22,654	88,158	7,283	0.95
Printing Presses/ publishing houses	6,479	20,880	1,664	1.98
Chemical prod./sub.	270,094	622,596	40,487	3.59
Petroleum/derivatives	22,319	167,710	5,127	0,09
Rubber products	22,236	78,253	6,037	4.00
Plastic products	30,956	66,061	718	3.91
Glass, china, clay	17,435	74,247	15,251	9.87
Steel and iron	20,333	228,886	2,575	0.96
Non-iron metals (copp)	8,368	42,763	14,205	0.00
Metal products	59,145	251,291	10,760	1.18
Non-elec. machinery	425,405	1,073,787	6,776	3.44
Elec. machinery/parts	159,576	584,432	2,225	4.74
Transp. material	118,815	601,941	27,573	1.40
Prof. equipment	8,682	58,781	3,836	3.06
Total	1,366,894	5,566,809	1,427,267	

Source: Central Bank and Bureau of Census

Table 7
Growth in Imports Resulting from a Chile-United States FTA
($'000, baseline 1990)

Sector	Imports		Welfare effect	
	Creation	Diversion	Creation	Diversion
Fishing and agriculture	1,144	2,423	63	266
Coal	1,932	2,296	106	253
Food, bev. & tobacco	2,286	2,294	126	252
Textiles	7,307	4,912	402	540
Paper	1,347	2,679	74	295
Chem. subs. or products	32,119	28,002	1,767	3,080
Rubber products	4,187	2,574	230	283
Plastic products	6,135	3,133	337	345
Glass, china, clay	3,456	2,099	190	231
Iron & steel basics	3,022	2,776	166	305
Non-iron metals (copp.)	1,576	1,040	87	114
Metal products	11,722	7,117	645	783
Non-elec. machinery	84,315	45,292	4,636	4,982
Elec. mach. & parts	31,628	18,633	1,740	2,050
Transportation material	18,839	14,750	1,036	1,623
Prof. and ophtalmological equipment	6,181	5,173	340	569
Total	223,210	152,700	12,277	16,797

Source: Valdes (1992)

Table 8
Aggregate Effects of Uniform Tariff
Reduction over Five Years

Year	Import		Welfare effect		
	Creation	Diversion	Creation	Diversion	Net
1	60.9	41.6	5.8	1.2	4.6
2	101.5	69.4	8.6	3.3	5.4
3	142.0	97.2	10.7	6.5	4.1
4	182.6	124.9	11.9	11.0	0.8
5	223.2	152.7	12.3	16.8	-4.6

Source: Valdes (1992)

The potential year-to-year effects of an FTA with a uniform tariff reduction over the course of five years are shown in Table 8. During these five years, the behavior resulting from the creation and diversion of trade would be linear. In terms of effects on welfare, we observe that up until the fourth year, earnings resulting from the creation of trade would be larger than losses caused by the diversion of trade. This means that the loss previously calculated at $45 million under the hypothesis that an immediate tariff reduction and a discount rate of 10 percent would be reduced to $15.8 million over the course of five years.

In a scenario in which tariffs are reduced at a slower rate for sectors that produce the greatest loss because of trade diversion, the net loss in welfare is even smaller than what is shown in Table 4.3. As a result, a slower duty reduction in those sectors that generate the greatest amount of trade diversion implies a significant reduction of the negative effect caused by the FTA. The net loss in welfare generated by an increase in imports is reduced to one fifth of what it would otherwise be (*see* Valdes, 1992).

Exports

Table 9 shows the effects of an FTA between Chile and the U.S. on the expansion of Chilean exports, using the extreme assumption that tariffs would be reduced to 0 percent immediately. Total exports to the United States would increase by $62.3 million, equivalent to 4.4 percent of total Chilean exports to that nation. This increase would be concentrated primarily in the areas of food, beverages, and tobacco ($19.3 million), agriculture and fish ($14.2 million), apparel ($9.0 million), and textiles ($4.6 million). The effects on welfare, on the other hand, add up to $32.7 million, which means that, assuming an annual discount rate of 10 percent, the FTA would create a benefit (at present value) in the area of exports equivalent to 330 million. The effects on welfare would be concentrated in the areas of food, beverages, and tobacco ($9.0 million, textiles ($5.3 million), mining-copper and iron, ($4.3 million), and agriculture and fish ($4.1 million).

Table 9
Expansion of Exports Resulting From A Chile-United States FTA
($ '000, base year 1990)

Sector	Growth in exports	Welfare effect
Agriculture and fishing	14,204	4,108
Mining (copper and iron)	642	4,327
Food, beverages, and tobacco	19,338	8,954
Textiles	4,592	2,820
Clothing	9,029	5,314
Leather and shoes	3,428	1,750
Chemical substances and products	3,280	1,511
Glass, china and clay	3,205	1,663
Total	62,290	32,683

a. Includes other sectors
Source: Valdes (1992)

Estimates of export expansion in Valdes (1992) differ significantly from the estimates in Erzan and Yeats (1992); the latter estimate that Chile would experience an increase of $22.8 million in exports to the United States upon signing an FTA. The fundamental reasons for this discrepancy are found in the base year chosen and the methodology used for the study. Erzan and Yeats (1992) use 1986 as the baseline year. In fact, if the effects of an FTA were calculated using 1986 as the base year, a recalculation of the figures in Table 9 would show that the increase in exports caused by an FTA to be $26.3 million. The small difference that exists between the Erzan and Yeats (1992) and Valdes (1992) studies results from the use of different elasticities.

Furthermore, it is worth pointing out that the estimates in Table 9 (as well as Tables 7 and 8) depend on the year used as the base. The results should be interpreted with caution. At the very least, this requires keeping in mind that an agreement would be implemented within two years at the earliest. Given that Chilean exports show a significant secular dynamism, the effects of an FTA on trade will have to be recalculated according to the most up-to-date information.

In summary: the effects of a Chile-U.S. FTA on trade (using 1990 as the base year) would be as follows:

(1) Chilean exports to the U.S. would increase 4.4 percent (with a value somewhat higher than $60 million);

(2) Chilean imports from the United States would increase by 27.5 percent (approximately $375 million), 16.3 percent from trade creation and 11.2 percent from trade diversion; and

(3) the effects of these changes on welfare would be equal to a net gain in welfare (using an intertemporal discount rate of 10 percent) of 1 percent of the GNP (approximately $310 million).

An FTA and the Environment

The issue of the environment was present throughout the NAFTA negotiations; it is also expected to emerge in negotiations with Chile. It has been discussed both in Chile and the United States. Labor and environmental groups in the United States fear that the strengthening of commercial ties with less-developed countries where environmental regulations are not as strict would result in "ecological dumping." In Chile, environmentalists perceive a negative relationship between trade and the environment.

Opposition is based on two potential effects of free trade. Because less-developed nations often have more permissive regulations with regard to pollution, they would have an advantage with respect to the production and export of products with more contaminating production processes. In addition, there would be a shift in investment to those countries. Both effects would lead to a reduction in employment in developed countries that are linked to less-developed, less-regulated nations; contamination would also increase in less-developed nations.

The theoretical and empirical evidence to support these arguments is weak, and is in many ways contradictory. From a theoretical perspective, it is obvious that each region has different capacities to absorb contaminating emissions, depending on the socioeconomic characteristics of each: acceptable contamination levels differ from one country to another. A higher level of emissions does not always lead to a higher level of pollution, nor does a higher accepted level of contamination necessarily mean that "ecological dumping" is taking place. Different values are placed on certain environmental conditions.

From an empirical perspective, we have seen that a proportional increase in costs that are part of environmental regulations are not enough to justify the relocation of factories. In fact, no such exodus of factories has occurred upon the implementation of these regulations. Factors such as transportation of goods to principal markets, the quality and cost of labor, and the political risks of operating in a given country tend to control these decisions.

Beyond the cost advantages resulting from different levels of regulation, a greater degree of liberalization also produces changes in the production structure. Those changes could lead to greater production in the most polluting industries. Along the same line, it is feared that in nations with a relative abundance of natural resources, liberalization will cause overexploitation of those resources and could even cause the collapse of this source of wealth. The counter-argument is that the exploitation of goods that are common property should be combatted through appropriate regulations and assignment of rights of ownership, rather than rejecting the advantages of international trade.

Finally, a fear exists that free trade agreements will inhibit the freedom of nations to impose regulations to protect their environments. This fear also appears to be unfounded, given that FTAs tend to adopt the obligations of the Codes of Standards of GATT, which allow for regulations that protect the environment as long as they do not discriminate against external producers and measures adopted accomplish the desired objective with minimal impact on the flow of trade.

There are estimates of the effect of trade liberalization on Chile's environment. These studies indicate that the restructuring of production following liberalization will decrease the pollution levels per unit of product once the least-polluting industries are expanded and those with the highest emissions are reduced. Nevertheless, the exploitation of comparative advantages will lead to higher natural-resource exports. In some cases—fishing—appropriate regulations are lacking, and the result is likely to be over-exploitation.

We believe that an FTA with the United States would have similar effects. That is, the least-polluting industries would grow, the export of natural resources would increase and perhaps incorporate higher levels of processing. Nevertheless, the effects would be relatively minor upon the initiation of the new process of tariff reduction from a low level of protection. On the other hand, the damage caused by the overexploitation of natural resources would be controlled by environmental regulations. The fishing law has already been approved, the native forest law is being negotiated, and a proposed environmental bill would penalize polluting activities and require an environmental impact study of proposed projects.

An FTA with the United States is expected to increase the flow of foreign investment to Chile. As mentioned previously, this increase could occur not so much as a result of improved access to the U.S. market (given that this type of incentive would lead to investment from Mexico), but as a result of the positive effect such an FTA would have on the international image of the country: the perceived risk of investment in Chile would decrease. Certain sectors may see this increase in investment as a threat to Chile's environment and fear invasion by polluting industries. However, evidence suggests that foreign companies tend to use technical standards equivalent to those in their own countries because of the pressure by environmental groups. This decision is also influenced by the anticipated cost of modifying production technology after an investment has been made should the recipient nation adopt stricter regulations.

The theoretical and empirical arguments that detract from the environmentalists' objections to free trade will be insufficient to eliminate the environmental issue from the agenda of trade negotiations. Theoretical arguments used to remove environmental issues from the agenda will be ineffective in changing public opinion and the posturing of lobbying groups, at least in the short term. From that perspective, it is interesting to consider the implications of the negotiation of a free trade agreement with the United States would be for Chile.

Unlike Mexico, Chile does not share a common border with the United States, and consequently there are fewer issues of conflict with regard to the environmental provisions of an FTA. The issue of having to come up with shared solutions is eliminated, and the potential for ecological dumping and the flight of industry is diminished by the high cost of transportation. Nevertheless, Chile has some serious environmental problems that could be used by opponents to an agreement with the U.S. One is the weakness of existing laws and institutions to regulate environmental impact. Solutions are being developed to these legislative weaknesses, but Chile's lack of resources and experience in this area pose significant obstacles.

The lack of resources is apparent not only in environmental regulation but also in the actual process of cleaning the air and hydraulic resources as well as the implementation of the cleanest production technologies. The trade-off between growth and solving the problem of poverty, on the one hand, and improved environmental quality on the other, becomes especially pronounced with respect to issues of urban environmental quality and mining production processes.

Despite the cost of adopting stricter standards, there is an awareness in Chile that the developed world will be increasingly demanding with regard to methods used in the production of goods it imports, and that products made with technology that is harmful to the environment will be rejected, either through foreign trade legislation or by consumers. That is why changes adopted in environmental regulations will not be seen not as requirements to achieve an FTA with the U.S., but instead as necessary changes to improve international standing and the quality of life in Chile.

The FTA will provide an appropriate opportunity to resolve controversies over environmental regulations. Chilean producers will also feel less threatened by protectionist measures that make use of environmental arguments.

Chile and MERCOSUR

Geography appears to play a critical role in the creation of common markets, and trade arrangements between neighboring countries tend to endure. On the other hand, once a trade agreement is established between two countries, the smaller country obtains a greater relative gain in welfare. These factors suggest the benefits Chile could anticipate from affiliation with MERCOSUR.

Moreover, Chile's most important Latin American trade partners are Argentina and Brazil. Table 10 shows the relative magnitude of Chilean exports and imports with Argentina and Brazil. Brazil and Argentina make up about 40 percent and 18 percent, respectively, of Chilean exports to Latin America; however, Chile's exports to these two countries make up a little over 8 percent of Chile's total exports.

The MERCOSUR created in 1991 has set December 1994 as the deadline for the final establishment of a common market.[6] This will require a time frame for reducing and ultimately eliminating tariff and nontariff barriers between the four member nations (Argentina, Brazil, Paraguay, and Uruguay), the establishment of a common external tariff (CET), harmonization of laws and policies dealing with foreign trade, and coordination of sectoral and macroeconomic policies.

Table 10
Trade Exchange Between Chile, Argentina, and Brazil

	-------- ARGENTINA --------			-------- BRAZIL --------		
	Chile[7] exports ($ mln)	Arg.[8] imports ($ mln)	Chile Exp. to Arg. Chile exp. - L.A. (percent)	Chile[7] exports ($ mln)	Brazil[8] imports ($ mln)	Chile exp. to Brazil Chile exp. - L.A. (percent)
1985	84	106	15.7	210	49	39.2
1986	161	123	23.5	293	248	42.8
1987	175	159	21.0	348	380	41.7
1988	168	279	19.3	342	555	39.2
1989	110	399	11.5	523	703	54.5
1990	114	503	11.2	487	564	48.0
1991	257	554	20.8	448	698	36.2

Source: Central Bank
* See footnotes 7 and 8.

The MERCOSUR Treaty allows for the accession of other ALADI member countries, but requests will be considered only after the treaty has been in existence for five years, with the exception of those presented by nations that "do not form part of subregional integration schemes or an

6. For a more detailed discussion of this subject, *see* Mizala (1992) and Saez (1992).

7. Chilean exports are FOB.

8. Imports from Argentina and Brazil are CIF.

extraregional association." This has been interpreted as a method of allowing Chile to join the MERCOSUR Treaty, given that at the time of its signing, Chile was the only country that met the condition. Argentina and Uruguay have repeatedly favored Chile's admission. It is not clear where Chile stands, and its official position vis-à-vis MERCOSUR has been extremely cautious. Interest exists in having this initiative succeed, but by observing from the outside looking in.

The effective implementation of MERCOSUR (Argentina, Brazil, Paraguay, Uruguay) would create an economic bloc with a GNP close to $400 billion, a population of almost 190 million inhabitants, a labor force of 75 million, and exports valued at $44 billion (1990 data).

Alejandra Mizala (1992) puts forth various alternatives that should be analyzed regarding Chile's incorporation or nonincorporation into MERCOSUR. Chile's marginalization from MERCOSUR could mean the displacement of Chile's competitive exports by those from trade associates who will benefit from tariff preferences. According to Mizala (1992), if we were to consider the extreme case of keeping only copper exports, Chilean exports to Argentina and Brazil would be reduced by $81.6 million and $276 million, respectively. This would mean a total reduction of Chilean exports of 4.3 percent (from the year 1990). A less extreme scenario suggests that MERCOSUR should not affect all Chilean exports that are not competitive with reciprocal exports from the member nations of MERCOSUR. In addition, other products would have to be added to copper. In that case, Chilean exports to Argentina and Brazil would decrease by $74.5 million and $165.7 million, respectively (Mizala, 1992). Here, the effect on total Chilean exports would be approximately 3 percent.

Chile's incorporation into MERCOSUR creates problems related to the acceptance of a higher external and differentiated common tariff, as opposed to the current uniform level of 11 percent. In addition, there are difficulties associated with neutralizing the microeconomic and macroeconomic effects that could be caused by macroeconomic instability in Brazil and (potentially) in Argentina. However, there would be certain benefits from joining MERCOSUR: the possibility of expanding Chilean exports, greater incentives for foreign investment given the attractiveness of being able to operate in an expanded market, and the increase in the country's negotiating capability at a bloc level rather than as a single country. Finally, it is possible that an FTA could be established with MERCOSUR and/or sectoral (bilateral) agreements with the various member nations of MERCOSUR. An evaluation of these alternatives requires a more detailed study.

Finally, another aspect of this issue merits attention. The creation of MERCOSUR is causing important economic liberalization and rationalization of foreign trade regimes by member countries. Even when an AEC is put into place that distinguishes between member and nonmember nations, those countries that do not form part of MERCOSUR will be in a relatively better position than in the past. This will allow for an increase in bilateral trade exchange with each of the MERCOSUR member nations. The increase in the level of bilateral exchange as well as the greater investment on the part of Latin American entrepreneurs in neighboring nations (a phenomenon already being observed between Chile and Argentina) will create even greater incentives for institutional and commercial bonds between Chile and MERCOSUR.

Summary and Conclusions

From Chile's point of view, the signing of a free trade agreement with the United States would be a positive step. Moderate benefits would be experienced in the area of trade, with the greatest benefit falling primarily among certain specific export sectors that currently face high tariffs in the U.S. Specifically, agroindustry would enjoy the greatest benefit, as it currently must face tariff schedules. Exports of apparel, textiles, and leather products would also grow.

The global effects of an FTA between Chile and the United States would be as follows (using 1990 as the base year):

(1) Chile's exports to the U.S. would increase by 4.4 percent (at a value of a little over $60 million);

(2) Chile's imports from the U.S. would increase by 27.5 percent (approximate value, $375 million) with 16.3 percent from the creation of trade and 11.2 percent from trade diversion; and

(3) the effects on welfare of these changes would be valued at a net gain in welfare (using the intertemporal discount rate of 10 percent) of 1 percent of GNP (i.e., approximately $310 million).

Beyond tariff reductions, an FTA with the U.S. includes conditions with regard to, inter alia, governmental purchases, trade in services, the elimination of restrictions on foreign investment, and protection of intellectual property rights. Chile, however, is either in the process of adopting, or has already adopted, the majority of these requirements. Despite this, significant institutional changes have yet to be made if greater levels of transparency, predictability, and regulation are to be achieved in this process.

Another clear condition of the FTA has to do with the environment. Chile will face significant pressure from the U.S. to implement stricter regulations with regard to activities harmful to the environment and will have to proceed more quickly than most would like. Nevertheless, it is clear that in order to ensure that Chile's products have access to developed markets, the environmental issue will be central to the debate.

While it is important to emphasize that entering into negotiations with the United States is beneficial from a trade perspective and gives Chile a seal of approval as an attractive country for investment, one cannot disregard the importance of inclusion in MERCOSUR. The market that these four nations comprise is sizeable: secured access to that market could be a significant motivating force for foreign investment. Today, Chile offers very attractive stability and nondiscrimination, but it cannot offer access to a broader market.

An FTA with MERCOSUR, where Chile maintains its independence vis-à-vis trade policy, would allow us a greater degree of diversification, both in terms of *markets* as well as *products*. In fact, over 60 percent of Chile's exports to the developed world consist of unprocessed natural resources. In contrast, only 35 percent of Chile's exports to Latin America consist of unprocessed natural resources.

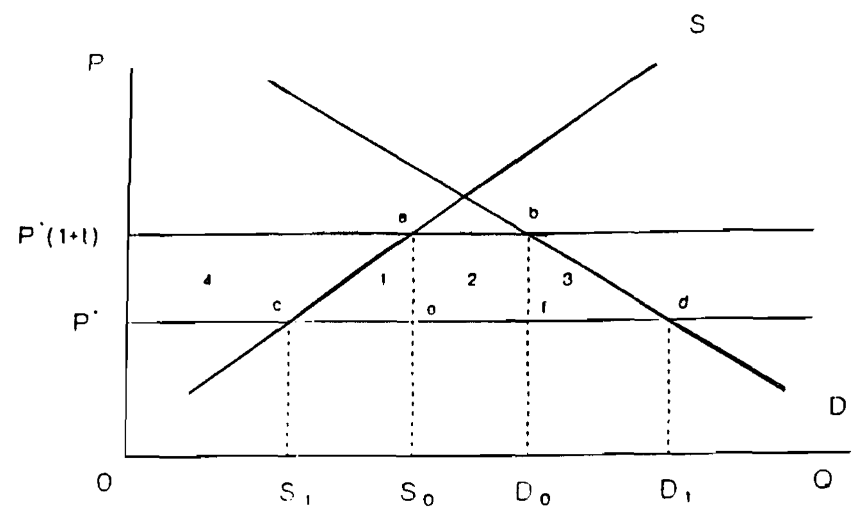
So while an FTA with the U.S. would be beneficial, the importance of Chile's integration with other Latin American nations—especially MERCOSUR, which would afford Chile's export sector other types of advantages—should not be discounted.

Technical Appendix

This technical appendix will examine the theoretical concept and simplifying assumptions associated with the empirical analysis of trade creation and trade diversion, as well as the expansion of imports that will result from implementation of an FTA.[9]

Figure A.1 presents the problem of trade creation. This analysis presents the equivalent of a unilateral tariff liberalization. Prior to the trade agreement, the local country has tariff *t* for a product whose international price is P* (Figure A.1). The local production level is OS_0 (point a) and the level of consumption is OD_0 (point b). The excess demand is met by *ab* imports. The establishment of an FTA causes a duty reduction, i.e., tariff *t* is eventually reduced to zero. This leads to a new level of consumption OD_1 (point d), in which production at the local level only supplies OS_1 (point c). The new excess in demand is eliminated through a high level of imports *cd*.

Figure A-1: Welfare Effect from Creation of Trade



To evaluate gains in welfare caused by trade creation, one must consider net gains in welfare. In fact, tariff reductions cause a domestic redistribution of welfare in the local country. (Extra) utilities generated by tariff *t* on producers (area 4, Figure A.1) are transferred to local consumers. Similarly, the collection of taxes resulting from tariff paid by imports (area 2, Figure A.1) are not paid when $t = 0$, which is a redistribution to consumers on the part of the government. Net gains in welfare caused by the creation of trade (induced by a reduction in tariffs) correspond only to triangles 1 and 3 (Figure A.1). Area 3 is associated with the additional net welfare received by consumers as a result of the expansion of the level of consumption of the product in question, and area 1 represents a net gain in welfare that is caused by the alternative use to which freed (or displaced) production factors are assigned as a result of trade liberalization. In addition, in this case the gain in welfare caused by the creation of trade would be 0.5 x *dM* x *t*, in which *dM* corresponds to the expansion of imports resulting from liberalization.

9. For a more detailed discussion, *see* Caves, Frenkel, and Jones (1990) and Valdes (1992).

In general terms, if M_{oj} is the quantity of product i imported from country j, t_0 the initial tariff level, d_t the preferential exchange of tariffs, and assuming that the level of elasticity (price) of the demand for imports is known, ξ_i, then $dM = d_t/(1 + t_0)\ d_t \times \xi_i \times M_{oj}$. As a result, the increase in welfare B_C caused by the creation of trade will be: $B_C = 0.5\ [dt/(1 + t_0)]\ d_t \times \xi_i \times M_{oj}$. This increase in Bc is directly proportionate to the initial value of imports (M_{oj}) coming from the country which is given the tariff preference.

Figure A-2: Welfare Effect from Trade Diversion

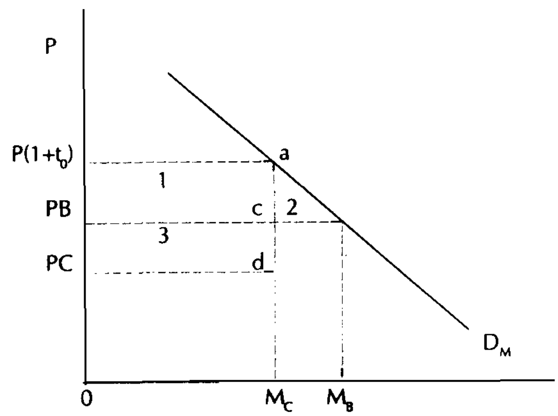


Figure A.2 demonstrates trade diversion that results when a product imported from country C, following the establishment of an FTA with country B, is then imported from country B. The tariff preference given to country B allows imports from country B to substitute those from country C (see Figure A.2). If D_M represents the demand for imports of product k from one country, in which the product faces tariff t_0, at the price of $P_C^*\ (1 + t_0)$, country C is the one which has the greatest degree of competitive advantage in order to supply the local country at a level of imports OM_C (point a). Once a preferential agreement with country B is established, in which this country can supply the local country without having to cancel the tariff previously paid for imports from country C, the level of imports is expanded to OM_B (point b). These products are now totally supplied by country B at the price of P_B^* (this is higher than the price P_C^* without a tariff that country C could offer). The diversion of trade causes a gain in net welfare for consumers associated with the reduction of tariffs that corresponds to area 2. Area 1 corresponds to a transfer of income from the taxes previously collected by the government, which is transferred to consumers. On the other hand, area 3 represents the net loss in welfare of the local country due to trade diversion. Area 3 corresponds to a portion of the tax collection that existed prior to the establishment of an FTA. Once the FTA is established, local consumers pay the difference in prices (P_B^* - P_C^*) on products from country B which are relatively less efficient than those from country C. If area 3 is greater than area 2, then trade diversion causes a net loss in well-being for the country.

To estimate the effect of the diversion of trade, we use elasticity to substitute between imported products o_j which come from two different countries, *B* (with a preferential tariff) and *C*.[10] In order to work this calculation, empirically it is useful to carry out some simplifying assumptions.[11] Let us suppose that the local availability of products remains virtually constant, i.e., the expansion of imports from country *B* corresponds to the reduction of imports from country *C*. Then, the loss associated with trade diversion would correspond to the magnitude of imports that have been diverted multiplied by the price differentials $(P_B^* - P_C^*)$. This procedure is the equivalent to that originating in the change of tax collection caused by the establishment of an FTA (for the corresponding derivation, see Valdes 1992).

Figure A-3: Effects of a FTA on Exports

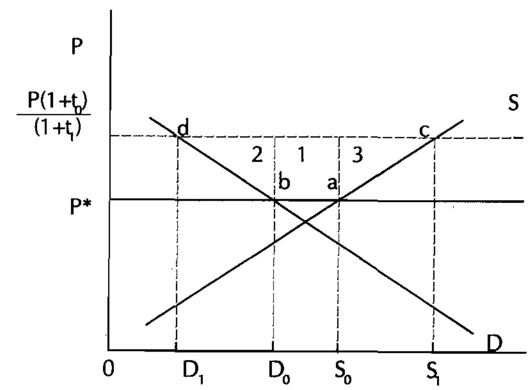


Figure A.3 demonstrates the phenomenon related to trade expansion caused by an FTA in the local country. In this case, we will assume that the local country is small (Chile) and the other country is large (the U.S.). Prices in the large country will not be affected by changes that the FTA causes in the small country. As a result, the variations in exports will depend on the price elasticity of the exports. In this case, since the small country will receive a preferential tariff, exports from the small country will receive a higher price than that paid prior to the establishment of an FTA. Figure A.3, using a model of partial equilibrium, illustrates this. Prior to the establishment of an FTA, the smaller country produced OS_o (point a), consumed locally OD_o (point b) and exported D_oS_o to the larger country. With the establishment of an FTA, the price for exports increases to [(1 + to)/(1 + t1)] x P*. This creates a new level of production OS_1, a reduction in domestic consumption to *OD1* and an expansion of exports in $(D_o - D_1) + (S1 - S_0)$. If *n* is the (price) elasticity offered by exports, then the increase in exports of product *j* caused by the FTA will be $DX_j = X_{jo} \times n \times [(t_o - t_1)/(1 + t_1)$, in which t_o and t_1 represent the tariff imposed on exports of product *j* prior to and after the signing of an FTA, respectively. Note that the calculation of expansion of exports is directly proportional to the level of exports X_{jo} which exists in the first moments following the establishment of an FTA.

10. We suggest using oj = 1.5; *see* UNCTAD (1989).

11. For more detailed discussion, *see* Valdes (1992).

Consider the perspective of the increase in welfare caused by exports under the FTA: first, the price increase to exporters for exports that were carried out prior to the FTA (area 1) and second, the additional expansion of exports (areas 2 & 3). The net effect on the welfare of exports caused by the FTA will be $B_x = X_o (t_0 - t_1) + 0.5 (t_1 - t_o) dX$.

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ECONOMIC RELATIONS OF BRAZIL AND THE UNITED STATES AND THE ENTERPRISE FOR THE AMERICAS INITIATIVE

Marcelo de Paiva Abreu[1]

Assessment of the relative virtues and shortcomings of regional integration as opposed to allegedly more elusive multilateral liberalization has been a major theme of recent work in trade policy. It is rare that such assessments acknowledge that specific national interests, in particular mixes of regionalism and multilateralism, will vary significantly depending on trade structures and trade policies. This paper is mainly concerned with trade relations and seeks to evaluate (i) the arguments that favor and oppose the economic integration of Brazil's economy with other economies in the hemisphere, and (ii) how relations between Brazil and the United States could be affected by alternative integration scenarios. Economic integration could result from either concrete developments or the creation of effective docking conditions for the extension of the North American Free Trade Agreement (NAFTA).

The wide differences in the speed of economic reform and the success of macroeconomic stabilization between the Latin American economies are obvious. Brazil's slowness in introducing structural reform, or the ineffectiveness of efforts to control inflation invalidate any unqualified assertion of the reversal of the economic climate in Latin America or stable improvement of relations with the United States. These contrasts are rooted in the past. It is thus difficult to assess Brazil's current policies and their likely impact on relations with the United States without a relatively long perspective that includes the abrasive 1980s. As it becomes increasingly likely that such bilateral frictions will return, that perspective becomes all the more relevant.

This paper begins by considering the impact of the economic crisis of the 1980s on Brazil-United States relations, in particular the significant deterioration in bilateral and multilateral economic relations affecting trade. Then it examines how, from 1988 on, these frictions were reduced by domestic economic reform (especially of trade policies) and the adoption of a more positive approach to multilateral trade negotiations in the GATT. The paper then assesses alternative implementation scenarios for regional integration initiatives involving Latin American countries and the United States and Canada (such as the NAFTA and the EAI) and examines the likely impact of each on Brazil. The conclusion considers how the increased importance of regional integration is likely to affect relations between Brazil and the United States.

Economic Relations Between Brazil and the United States in the 1980s

Several significant irritants were inherited from the 1960s and 1970s.[2] The policy of close political alignment with the United States, which prevailed in the period immediately after the 1964 coup,

1. The author thanks Rubens Ricupero, Ron Sprout, and José Tavares for their comments and Clarice Gonçalves Silva for research assistance.

2. Lima (1986) is a standard treatment of Brazil-U.S. relations, especially in the context of nuclear energy and trade.

led to a reversal of stances in international forums. Examples include the cases of reservations Brazil placed on some of the principles included in the Final Act of the UNCTAD Geneva Conference of 1964, and participation of Brazilian troops in the intervention in the Dominican Republic in 1965.

After 1967, Brazil's negotiating stance started to change. In the talks leading to the Treaty for the Prohibition of Nuclear Weapons in Latin America signed at Tlatelolco, Mexico, in 1967, Brazil did not waive the requirement of full ratification as a precondition for effectiveness. Brazil also did not sign the Nuclear Non-Proliferation Treaty of 1968 and cited national security interests as the rationale for the maturing of policies which tended increasingly to assert Brazil's autonomy in relation to the United States.

Brazil's position also began to shift in trade negotiations. In the UNCTAD meeting at New Delhi in 1968, Brazil withdrew its reservations of 1964 and took an active part in the negotiations that led to the introduction of the Generalized System of Preferences by all developed countries despite the marked reluctance of the United States.

The sharp rise of oil prices after 1973 tended to reinforce, rather than defuse, latent or overt bilateral frictions, given Brazil's dependence on imported oil. In the nuclear field, in 1975 Brazil signed with the Federal Republic of Germany an Agreement Concerning Cooperation in the Field of the Peaceful Use of Nuclear Energy, which involved the construction of several nuclear power stations, transfer of sensitive technology in uranium enrichment, and production and reprocessing of nuclear fuels. This move marked a merge of economic—that is, prospective energy-saving—arguments with those that underlined the usefulness of the agreement from a more political point of view, especially regarding bilateral relations with the United States.

The Carter administration abandoned the Ford administration's emphasis on Brazil-United States relations because Brazil was an emerging regional power center. The United States reacted strongly against the Brazil-Germany Nuclear Agreement and also pressed the Geisel administration to improve its human rights record. Resulting frictions led to the denunciation of the long-standing agreement on military cooperation.

Brazil adopted an increasingly aggressive stance in its bilateral relations in the Middle East and Africa for the purpose of assuring long-term oil supply and to use oil purchases as a lever to increase exports through countertrade deals. Since these deals entailed a mushrooming of military equipment exports, it is not surprising that the domestic coalition backing these new policies gained considerable strength. Partly because of oil, but also as a natural backlash given its former stand in favor of Portugal in Portugal's colonial conflicts in Africa, Brazil struck a high profile especially in Southern Africa to reassert its foreign-policy independence in relation to the United States.

In high-technology goods and intellectual property there was also a buildup of friction as Brazil targeted strategic sectors such as electronics and pharmaceuticals to benefit from government support because of their key role in assuring self-sustained, endogenous development of required technologies. The introduction of a regime of absolute protection to domestic production of microcomputers is only one example of such policies. Domestic support for such regimes was assured by a blend of lobbies based on concerns for national security, sovereignty, and appropriation of scarcity rents.

Brazil was not very active in the GATT before the Tokyo Round. Toward the end of the Round, however, in the negotiations of both the so-called Framework Group and the GATT codes, Brazil took a more active role.[3] The negotiations in the Framework Group[4] originated from Brazil's proposal to provide a legal basis for GSP. This would require the consolidation of preferences and establish liability to compensation in the event they were withdrawn, as well as more flexibility in the use of article XVIII for balance-of-payments purposes.[5] Negotiations resulted in the consolidation of the derogation, which legalized nonreciprocity based on special and differential treatment.[6]

The United States, dissatisfied with what was seen as consistent pursuit of inappropriate advantage by developing countries, emphasized the importance of negotiating specific codes that attempted to limit MFN treatment to signatories. From Brazil's point of view the code on subsidies was the most important to be negotiated in the Tokyo Round. For code signatories the application of compensatory duties should be based on proof of injury to domestic industries. Brazil's negotiators yielded to United States pressures and agreed to the gradual removal of tax credits tied to export performance as well as to the freezing of export subsidies.[7] Brazil was the first developing country to sign the code on subsidies. Other developing countries that followed as signatories made less significant concessions, as is evident in the vague undertakings required for India and Pakistan.[8]

The marked deterioration in economic relations between Brazil and the United States in the 1980s had both financial and commercial components. In the financial field, frictions were diffuse and frequently involved the intermediation of the International Monetary Fund and the World Bank and also affected commercial banks other than those in the United States. The main exception was an incident caused by Brazil's great financial vulnerability at the end of 1982 that led to a sudden weakening of its bargaining position. When Brazil needed a United States Treasury bridge loan, the U.S. government successfully pressed Brazil to soften its stance of resisting the inclusion of the so-called new themes in the GATT Ministerial Declaration. In 1987 financial relations between the two countries reached their nadir (since the early 1960s), and Brazil declared a foreign-debt moratorium. The renewed moratorium in 1989 was less abrasive, some trade liberalization was already taking place, and it was clear that some of the political constraints to debt normalization could be removed after the first free presidential election in 29 years.

Difficulties related to bilateral and multilateral commercial issues were much more explicit and permanent. The United States' active imposition of antidumping and subsidy countervailing duties in the 1980s had a significant impact on Brazilian exports. In several instances Brazil faced United States

3. See Abreu (1992) for Brazil's role in the Tokyo Round.

4. From *The Legal Framework for Differential and More Favourable Treatment for Developing Countries in Relation to GATT Provisions.*

5. See Maciel (1978) and Winham (1986), pp. 144-146. The original document, which incorporates Brazilian proposals is entitled Statement by the Representative of Brazil, Ambassador George A. Maciel, 21 February 1977, GATT MTN/FR/W/1, of the same date.

6. See Winham (1986), p.274.

7. See Lima (1986), pp. 330-336.

8. See Hufbauer (1983), pp. 341-2 and Winham (1986), pp. 222-3.

actions, or was considered as a target for US actions, under Section 301, "Super 301," and "Special 301" of the Trade Act of 1974.

Antidumping and subsidy countervailing duty actions are difficult to assess. Compared to other developing and centrally planned economies, Brazil was a significant target for AD initiations in the United States from 1986 to 1988, and less so from 1988 to 1990. Other countries similarly affected were China, Taiwan, South Korea, and South Africa. Brazil has also faced many CVD actions, mainly between 1982 and 1986. In three of these years it led, or shared the lead on, the list of affected countries. (Other countries similarly affected besides those mentioned in relation to AD actions were Mexico and Venezuela.)

Of the wide range of Brazil's exports affected by AD and CVD actions, the most important were iron and steel products, chemical and petrochemical products, orange juice, textiles, and footwear.[9] Brazil's steel and iron exports to the United States were affected by VERs from 1984 to 1992. Similarly, Brazilian exports of textiles and clothing are constrained by export limitations negotiated bilaterally under the Multi-Fiber Arrangement.

Brazil was less affected by AD and CVD actions in the second half of the 1980s, at least in part because of the use of other protectionist instruments. Brazil has faced actions under Sections 301 of the Trade Act of 1974, as amended, "Super 301," and "Special 301." Of 87 of such initiations between 1975 and October 1991, six were against Brazil (the Republic of Korea faced eight initiations; Taiwan and Argentina, five; and India and China, four).[10]

Brazil was the only developing country to suffer retaliation under Section 301. It was designated as one of the priority countries under Section 301 because of its import licensing system. The October 1988 action by the United States imposing tariffs of 100 percent on Brazilian paper, pharmaceuticals, and electronic products entering the United States followed a complaint by the Pharmaceutical Manufacturers Association that Brazil's intellectual property rights legislation did not provide adequate protection for U.S. patents.

The other important 301 case affecting Brazil was related to its informatics policy, in particular software legislation. The case was initiated by the USTR in 1985 and was based on grievances concerning access to the Brazilian software market, protection of intellectual property in relation to software and hardware, and administrative procedures adopted by the Brazilian authorities in the informatics sector. It was terminated in October 1989 after changes in Brazilian policies.

Deterioration in Brazil-United States relations also resulted from different stances adopted in multilateral forums, especially in the GATT. On the one hand, there was a natural process of multilateralization of some of the bilateral disputes, and some were raised in the GATT. On the other

9. For a complete list of actions between 1979 and 1990 see the annexes of Destler (1992) as well as, for earlier actions, IPEA/CEPAL (1985).

10. See GATT (1992), p. 127 and GATT (1989), pp. 260-65. Initiations against Brazil affected footwear, informatics products, soybean oil and meals, import licensing, and patenting of pharmaceutical products and processes.

hand, there was much scope for different stands between the two countries in relation to the latest round of multilateral trade negotiations.

In the 1980s there were many consultations and panels concerning Brazil in the GATT, both as a complainant and as a defendant.[11] But by far the most significant issue of Brazilian bilateral interest to be discussed in GATT in the 1980s was related to retaliatory action by the United States in 1988 that imposed tariffs of 100 percent on selected Brazilian paper, pharmaceuticals, and electronic products entering the United States. It was perhaps the most extreme demonstration of how far the United States was willing to go to keep pressure on Brazil to improve access to its market and also to assure enforcement of stricter intellectual property legislation.

Brazil asked for a panel to consider questions of principle involved in the United States' action. The United States stalled, but a panel was eventually established in early 1990. There was no agreement on its terms of reference because the U.S. insisted that the substantive Brazilian legislation be examined, but Brazil centered its case on the conflict between the U.S. action and GATT rights and obligations. Terms of reference limited the panel to examination of compatibility of the action with GATT. The U.S. faced much criticism in the GATT because it made no effort to settle the dispute using GATT machinery.

In the strictly multilateral scene there was continuous friction between the two countries during the period preceding the launching of the Uruguay Round. A small group of developing countries, of which Brazil was a key player, objected to the inclusion of the "new themes" (trade-related investment measures, intellectual property, and services) in its agenda. Developing countries feared this would undermine their emphasis on unfinished business from previous rounds. It was also thought unlikely that it would be possible to reach agreements that would yield roughly equivalent concessions inasmuch as traditional GATT negotiation procedures were followed.[12]

With the de facto inclusion of the "new themes" in the Uruguay Round negotiations in Punta del Este in 1986, and partly due to internal developments, Brazil started to move toward a more active role as a *demandeur* after 1987. It was fortunate that Brazil had a credible and natural fall-back position as an initial (but far from enthusiastic) member of the Cairns group of fair (and not so fair) traders in agricultural products of temperate regions.

11. As a complainant: The Brazil-Spain 1980 panel on the tariff treatment of unroasted coffee, the consultations held in 1982 on the EC sugar export refund system in which Brazil was one of the ten countries involved, the 1986 Brazil-US consultations on US tariff on ethyl alcohol, the protracted Brazil-U.S. dispute on CVD duties charged on non rubber footwear and the 1988 Brazil-US consultations on the unfavorable impact of US subsidies under the Export Enhancement Program on Brazilian exports of soya bean oil. As a defendant: the U.S. 1983 complaint on Brazilian violation of Code of Subsidies in relation to poultry exports, the US-Brazil 1987 aborted consultations on restrictions on micro electronic products and the US 1989 complaint on the Brazilian quantitative import control regulations. For data see GATT, *GATT Activities*, several issues, as well as GATT (1989 and 1992).

12. For the evolution of Brazilian stance in the GATT see Abreu (1992). For countries without much bargaining power it became increasingly clear that it would be impossible to try to apply the equivalence of concessions rule. It became increasingly common to justify the advantages of liberalization based on standard efficiency grounds for "small countries." It is, however, less common to find acknowledgement that efficiency rules are not necessarily coherent with the commercial policy of contracting parties with negotiating clout.

Between 1987 and 1988, Brazil started to play an increasingly important role in agricultural and other negotiations. As agriculture became the main stumbling block to progress, Brazil played an important role in the GATT Midterm Review in December 1988 by assuring support for the stand of the Latin American members of Cairns, and then by the Cairns group (endorsed by the United States) of conditioning results in all negotiating groups to progress in agricultural liberalization.

Impact of Domestic Economic Reform on Relations Between Brazil and the United States

Domestic reform since 1990 played an important role in drastically reducing friction between Brazil and the United States. Prompted by a mixture of disappointment with the performance of the economy, the deepening fiscal crisis, wear and tear of interventionist policies, and international pressure, the Brazilian policy of export promotion and import repression had already started to change in 1987. Between 1987 and 1989 the list of products affected by de facto import prohibitions was progressively reduced, other nontariff barriers were removed, and tariff rates were reduced, but the level of protection remained substantial and nontariff barriers formidable. The average nominal tariff was in the region of 35 percent at the end of 1989 (the maximum was 85 percent). Most effective rates of protection were between 30 percent and 60 percent, but some—transport equipment—reached more than 150 percent.

When a new administration took office in March 1990, there was a significant redirection of economic policy. New policies covering price stabilization, foreign debt renegotiation, and structural reform were implemented, but almost from the start the new administration's credibility was marred by its ambiguous reform of long-established corruption. It is difficult to oppose legal rent-seeking behavior and at the same time engage in or condone openly corrupt practices.

The failure, after several attempts, to achieve price stabilization obscured concrete progress toward other economic objectives such as debt renegotiation and structural reforms.

Since early 1991, much progress has been made in renegotiation. After a January 1992 agreement with the IMF on macroeconomic adjustment, agreements followed with the Club of Paris (on foreign official credits) in March 1992 and with the private banks in July 1992. By the end of March 1993, more than 95 percent of Brazil's creditor banks had accepted the agreement, even though it contained a mix of options that differed from initial government expectations.

The program of structural reforms introduced by the Collor administration included elements of privatization, deregulation, and trade liberalization. Privatization has proceeded somewhat slowly because of legal actions against privatization, constitutional restrictions of privatization in sectors such as oil exploration, refining, and transportation, and emphasis on a transparent, market-oriented process.

It is indeed remarkable that during the Collor administration the process was, on the whole, free from accusations of corruption despite wide differences of opinion on its conception and implementation, in particular concerning the almost exclusive use of several types of heavily discounted government securities. The privatization program has been quite successful if account is taken of constraints. Usiminas, the largest Brazilian steel mill (output of 4 million tons per year), and Copesul, an important petrochemical upstream plant (sold for $1.3 billion) were the most important privatization cases. Foreign capital, however, has not shown interest in the privatization effort, an indication of a lack of confidence in the success of price stabilization efforts. Under President Franco, privatization policies have become more centralized and more vulnerable to discretionary decisions.

Deregulation of domestic activity mostly affected the pricing of inputs such as steel and fuels, which had been subjected to the distortions of strictly enforced national prices.[13] Much remains to be done in deregulation, but it is unlikely that Congress will approve sufficiently liberal legislation on most relevant issues. After Collor's impeachment new legislation was introduced on the deregulation of labor supply arrangements in ports and on increased competition in the use of port facilities.

Trade liberalization included the elimination of prohibition in the import licensing process and of most nontariff barriers, the reformulation of the system of export incentives, and the introduction of a multiyear tariff reduction program to reduce average tariffs from 32 percent (with a maximum rate of 105 percent) to 14.2 percent (with a maximum rate of 35 percent) by October 1993. Liberalization also reduced bureaucratic requirements affecting imports and exports, discontinued state monopolies in the trade of wheat, coffee, and sugar, and dismantled the main state trading company. The list of imports and exports requiring prior government approval was drastically reduced, and nontariff protection affecting electronic products was also abolished.

There is scope for further liberalization, mainly of national content requirements for access to official credits or to public procurement. The relaxation of restrictions on the right of establishment of foreign firms in certain sectors, especially in services, provides much scope for efficiency improvement. However, powerful industrial and trade-union lobbies have opposed the approved tariff reduction schedule, and the possibility of a reversal of the liberalization trend cannot be dismissed.

The shift toward liberalization removed frictions with the United States generated by trade relations. The removal of import licensing eliminated the basic reason for Brazil's designation as a priority target. Similarly, undertakings by the Brazilian government to propose intellectual property legislation that would considerably improve protection and allow process patenting led to removal of "retaliatory" tariff rates by the United States and eventually to withdrawal of complaints in the GATT while these changes were still being considered by the Brazilian Congress. Changes in the legislation concerning informatics addressed U.S. complaints in the sector.[14] The shift in U.S. trade policy towards a more liberal Brazil was also expressed by the reversal of a long-standing U.S. policy concerning graduation of products enjoying preferential treatment under GSP as preferences were restored in 1990 for products whose trade covered about $0.5 billion. AD and CVD actions became less frequent, but in early 1992 the end of the arrangements that limited the supply of Brazilian steel products in the U.S. market led, as would be expected, to a number of antidumping initiations.

In the GATT, not only were multilateral frictions originating from bilateral difficulties removed, but Brazil also tended to take a more active stance in negotiations, including the "new themes." In the Geneva meeting Brazil played an important role in the coalition that refused to proceed without a commitment by the EC and other countries that protect their interests in temperate agriculture to liberalize

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13. Foreign trade deregulation was significant but is treated below under trade liberalization.

14. The shift in US trade policy towards a more liberal Brazil was also expressed by the reversal of a long standing US policy concerning graduation of products enjoying preferential treatment under GSP as preferences were restored in 1990 for products whose trade covered US$ 0.5 billion.

their policies in more significant ways. After a year's stalemate, the GATT Secretariat presented a draft of the final act that embodied the results of negotiations since 1986, and Brazil indicated willingness to accept it despite reservations.

More recently, minor problems emerged in the GATT. The old Brazil-United States dispute on CVDs on Brazil's exports of nonrubber footwear flared up as Brazil, with support of other contracting parties, has blocked adoption of the panel's report in favor of the United States. Similarly, the U.S. blocked, at least temporarily, Brazil's somewhat odd attempt to obtain GATT approval of its MERCOSUR arrangements under the Tokyo Round Framework agreement, which assures developing countries special and differentiated treatment, rather than under the theoretically more exacting (but notoriously laxly applied) Article XXIV. In mid-October 1992, Brazilian commercial policy was for the first time assessed under GATT's Trade Policy Review Mechanism with a quite favorable outcome, which fully recognized the liberalization efforts undertaken in the recent past.

New Directions in Latin America's Economic Integration

Proposals and alternative implementation scenarios for economic integration encompassing Latin American economies and the United States have varying implications for Brazil. Relevant integration initiatives include the NAFTA, and a Western Hemisphere Free Trade Agreement (WHFTA). The MERCOSUR initiative is relevant only when it constrains or fosters economic integration of Brazil and the U.S.

Regional economic integration has been hailed by many as more likely to promote trade liberalization than multilateral negotiations conducted in the GATT. However, it is not easy to show the unqualified inherent economic advantages of taking regional economic integration as a road leading to a global market unhindered by obstacles to the free flow of goods, services, and factors.[15] Advantages are likely to vary substantially with the individual characteristics of different economies.

Some arguments are based on political expediency to show the advantages of regionalization over globalization. Other frequent arguments that underline the advantages of regional integration stress that FTAs assure access to markets that would otherwise be further restricted, and they lock in liberalization commitments. The advantages provided by GATT's tariff bindings for locking in liberalization, especially in the case of small economies, have been somewhat disregarded.

The theory of collective action has been suggested to explain why a small number of countries interested in regional integration, with more apparent sectoral interests, are more likely to succeed than a large number of countries aiming at the successful conclusion of multilateral trade negotiations, of which the benefits are more widely spread. This view surely underestimates the importance of differences in size, bargaining power, or both among the GATT contracting parties. The theory of collective action

15. See, on this, Lawrence (1991) and, especially, Bhagwati (1992), who stresses the conflicts between regionalism and multilateralism. See also Lawrence (1991) and Fishlow and Haggard (1992) for views more inclined to see the advantages of regionalism.

is more relevant to explaining the past troubles of the GATT, which were essentially due to EC objections to the extent and pace of agricultural liberalization.[16]

In sharp contrast with the 1960s, recent integration initiatives involving Latin American economies include as an explicit end the goal of increased access to United States markets. This has become possible as the levels of tariff and nontariff protection in Latin America have dramatically decreased in the last decade. As it is clear that NAFTA takes precedence over WHFTA on the U.S. agenda, it makes sense to consider NAFTA first, its implications, docking provisions, and compatibility with WHFTA or other regional integration arrangements that do not include the U.S., such as MERCOSUR.

The NAFTA Agreement is complex, and it has many direct and indirect implications for Brazil's interests. In relation to trade in goods, NAFTA provides for the progressive elimination of all tariffs. In most cases tariffs will be phased out immediately or in annual stages over five to ten years. For especially sensitive products, the time will be extended to 15 years. It is important to analyze different scenarios concerning NAFTA, particularly in relation to its treatment of access of products most affected by United States protection and likely to be of special interest to Brazil, such as sugar, orange juice, and certain manufactured goods.

One of the most restrictive features of the agreement on trade in automotive goods is the high level of North American content (62.5 percent) required to qualify for preferential treatment. Similarly, trade in textiles and apparel requires North American triple transformation, or "yarn forward" rules of origin.

Liberalization of trade in agriculture will take, in certain cases, up to 15 years. Mexico and the United States agreed to eliminate all nontariff barriers to their agricultural trade through conversion to tariff-rate quotas (TRQs) or tariffs. Up to the quota threshold, trade will be duty free; duties applied to trade exceeding quota limits will be phased out over ten to 15 years.

Sugar and orange juice are the most important products in the United States market to qualify for special treatment. In both cases Brazil's exports to the United States are significant. Sugar TRQs will be applied in the sixth year after NAFTA takes effect.[17] After 15 years, all restrictions on sugar trade will have been abolished except certain U.S. provisions on sugar re-exports. To increase its quota, Mexico will have either to increase productivity or shift to the use of corn-based sweeteners in its substantial soft drink industry to release sugar for export. Special agricultural safeguards can be applied during the first ten years.

While some Latin American economies—Mexico (more than 70 percent),[18] Venezuela (around 55 percent), and Colombia (around 45 percent)—depend on North American markets, they are less important for Brazil (under 30 percent) and Argentina. These other large Latin American economies depend on European markets (25-30 percent) and markets in Eastern Europe and other developing

16. See *CEPR Bulletin*, 50-51, April/June 1992, p. 18.

17. Brazil's sugar quota in 1992 was 169,084 tons, equivalent to about $75 million.

18. Data from 1988 unless stated otherwise.

economies, especially Argentina. Import commodity structures, on the other hand, to a large extent define the origin of imports. Oil-dependent economies such as Brazil purchase a lower proportion of imports in developed countries and a larger share in West Asia. In 1991 less than 20 percent of total Brazilian exports were purchased by the U.S., while U.S. imports made up 23.6 percent of total Brazilian imports.

Table 1 shows the 1989 shares of Brazil, Mexico, other developing Latin American countries, and other suppliers in total United States imports of products relevant to Brazil. Products included in the list correspond to more than 79 percent of total Brazilian exports to the U.S. in 1991.

There is no competition in the U.S markets between Brazil and Mexico for iron and aluminum ores, pulp and waste paper, and gasoline, and only marginal competition in footwear, of which Brazil's exports to the United States amounted to $2,070 million in 1989, 23 percent of Brazilian exports to the U.S. In most other products there is competition between Brazil and Mexico for the U.S. market. Other Latin America and Caribbean countries also compete with Brazilian products for the U.S. market, but their exports to the U.S. of orange juice, pulp and waste paper, and all manufactured goods with the exception of electrical machinery, clothing, footwear, and scientific equipment are insignificant; 44 percent of Brazil's exports to the U.S. do not compete with those from LAC countries other than Mexico.

Among the largest Latin American countries, Brazil was, in 1986, the most affected by tariffs and by both tariff and nontariff barriers in the United States. Incidence of all NTBs was marginally lower on imports from Brazil than on those from Argentina and Mexico, but Brazilian exports were relatively more affected by hard-core NTBs (quantitative restrictions and flexible import fees).[19] Tariffs on Brazilian exports are generally low (under 5 percent) except in the case of tobacco, copper, and tin manufactured goods, which varied between 10 percent and 17 percent. Some of Brazil's most important exports to the U.S., however, face significant nontariff barriers: orange juice (excise), sugar (quota), steel products (VERs in the past, now CVD actions), and textiles and clothing (under the MFA).

Estimates of static trade diversion caused by NAFTA suggest that the total value of trade diverted would be only about $441 million, of which no more than $35 million would be of Latin American origin. Brazil would be the largest loser, with diverted exports of $18.3 million, roughly half food and agricultural exports and half manufactured goods. Trade diversion would be dwarfed by the expected income effects of NAFTA generated by a comprehensive liberalization program that goes far beyond liberalization of trade in goods.[20] Trade diversion of Brazil's exports is zero for many products—crustaceans, nuts, coffee, pulp and waste paper, iron and aluminum ores, rubber products, and gasoline—either because tariff rates in the United States are zero or because Mexico's exports to the U.S. do not exist. Most trade diversion affects orange juice, since Brazil is the dominant supplier to the U.S. and protection of orange juice is high in the U.S.

19. See Erzan and Yeats (1992b), tables 5 and 7.

20. Erzan and Yeats (1992b), box 1. Assessment of NAFTA trade diversion affecting Brazilian products is in line with findings on Kreinin-Finger "export similarity measures" of pairs of developing Latin American countries which placed the Brazil-Mexico pair in the top position, that is as the pair of countries with the most similar export structure to the U.S., see Erzan and Yeats (1992a), box 3.

Table 1
United States
Origin of Imports by STIC or Groups of Products, 1989
(percent)

		Brazil	Mexico	Other dev. countries in the Americas	Other suppliers	Total imports ($'000)
036	Crustaceans	3.61	13.13	29.01	54.25	2,511,091
057.7	Nuts	26.51	5.2	5.36	62.77	312,383
059.1	Orange juice	86.41	10.23	2.86	0.50	569,529
061	Sugar	4.36	5.43	47.79	42.42	891,136
071	Coffee	19.81	19.90	40.84	19.45	2,577,408
12	Tobacco	14.81	2.74	12.06	70.40	799,072
251	Pulp, waste paper	7.39	0.26	0.30	92.04	3,164,367
281	Iron ore	19.21	0	21.78	59.01	608,859
285	Aluminum ore	4.63	0	18.01	77.36	1,708,535
334	Motor gasoline	9.61	0.92	31.87	57.59	5,641,958
62	Rubber	2.93	2.61	0.59	93.87	3,815,576
65	Textiles	3.21	2.89	3.01	90.88	6,416,502
657.5	Cordage	31.44	9.77	4.58	54.20	151,163
67	Iron and steel manuf. goods	5.85	2.77	2.93	8.45	11,376,408
682	Copper manuf. goods	3.46	9.13	22.71	64.70	2,238,669
687	Tin manuf. goods	27.30	5.12	15.66	51.92	343,785
71	Power generating mach.	4.16	8.38	0.13	87.33	14,488,108
72	Special industrial machinery	1.73	1.13	0.08	97.06	13,390,418
73	Metalworking machinery	0.50	0.20	0.05	99.26	4,004,817
74	General industrial machinery	1.66	4.86	0.20	93.28	14,973,973
75	Office machines	0.18	2.96	0.09	96.78	26,251,716
76	Telecommunications	0.05	11.33	0.08	88.54	23,603,881
77	Electrical machinery	0.54	12.75	0.87	85.85	33,033,977
78	Road vehicles	0.92	3.26	0.08	95.74	73,842,585
79	Other transp. machinery	2.79	0.63	0.12	96.46	7,217,377
84	Clothing and accessories	0.69	2.29	8.79	88.23	26,025,982
85	Footwear	12.46	1.95	2.27	83.31	8,795,664
87	Scientific equipment	0.22	7.90	1.31	90.57	5,964,037
88	Photo and optical equip.	1.80	1.60	0.08	96.52	5,997,122

But even then, trade created by NAFTA is small. Mexico is not an important exporter to the United States. Trade diversion is therefore also quite small, and it is unlikely that footwear exports will be substantially diverted as levels of protection are low, with tariffs around 5 percent and no recent NTBs.

For most products, however, the *potential* trade diversion of NAFTA is likely to be far more significant than the static one. Preferential tariff treatment of Mexico in the United States will stimulate investment in Mexico by United States and other country producers of goods now protected in the U.S. Incentives for new investment are likely to be more important in sectors that are more protected. The main products of interest to Brazil that in principle could be substantially diverted after a time lag of five or more years, are orange juice, steel products, sugar, and textiles. In most cases Mexico will have difficulty raising present productivity to levels required to increase its market shares in the U.S. substantially.

The EAI, announced in June 1990, was based on three pillars: integration of trade in a free-trade arrangement, promotion of foreign investment, and reduction of foreign debt. The trade integration proposals are likely to be more significant than those on investment and debt. Liberalization of foreign investment regimes is to be fostered through two IDB-administered programs: a limited technical assistance program and a multilateral investment fund. The reduction in debt service is unlikely to provide significant relief, especially for Brazil: the Overseas Development Council estimated the likely debt-service relief over the period 1991-94 to be $287 million. Japan has contributed to the multilateral investment fund, but it is difficult to predict that the EC will cooperate enthusiastically in the provision of additional funds to an initiative that is clearly a counterbalance to its regional integration initiatives. The trade element of the EAI has in any case been clearly dominant as the NAFTA negotiations have achieved success.

Under the EAI framework, agreements have been signed with many countries and groups of countries. The Rose Garden agreement of May 1991 was signed with the four members of MERCOSUR. These agreements are quite general, first steps in the negotiation of matters of relevance.

Although a "hub and spoke" model of integration involving the United States and Latin American economies would be possible, the success of NAFTA negotiations suggests as more likely that docking to NAFTA may in due course become the standard way for Latin American countries to achieve economic integration with the United States. As the entry of new members erodes formerly established preferences, it is to be expected that negotiations of new accessions, especially of larger applicants with a productive structure similar to Mexico's, will face Mexican resistance.

Estimates of the impact of the preferential removal of trade barriers in the United States market on exports of Latin American countries suggest that export gains are heavily concentrated in Mexico and Brazil. Of a total export expansion of $3,208 million, $1,640 million would benefit Mexico and $947 million would benefit Brazil. In fact, the 14.2 percent expansion of Brazilian exports is higher than the 9.6 percent estimated increase in Mexican exports because energy products—which enter the U.S. practically duty free—are an important share of total Mexican exports to the U.S. Total Latin American exports would increase 8 percent while exports from countries such as Chile, Peru, Bolivia and Ecuador would grow less than 3 percent. These estimates refer to exclusive FTAs of each Latin American country with the U.S., but they would not be significantly different in a scenario where all Latin American countries were integrated to the U.S. but not linked to each other.[21]

Incentives to integrate, however, may have little connection with static trade gains. Integration with the United States may be seen as the best insurance against new trade restrictions in the U.S., as the most effective means of locking in elements of trade reform, or as part of a policy package to attract foreign investment.

Concrete interest in proposals for economic integration with the United States varies considerably with the structural characteristics of specific Latin American economies. Other factors may outweigh the advantages of improved access to the U.S. market. This is the case of Brazil which, among the larger Latin American economies, is the least likely to be enthusiastic about integration with the U.S. in spite of the fact that it would enjoy, after Mexico, the greatest export expansion in a FTA with the U.S.

Brazil's benefits in entering a FTA with the United States would be relatively important given the high value of its exports to the U.S. and the high price elasticities of demand for its exports. Tariffs and NTBs significantly affect its exports to the U.S. Brazil's gains are limited by the diversification of its export markets since its share of exports to the U.S. is lower than that of most other Latin American countries. Exports to the U.S. have been losing importance since the record year of 1984, when the U.S. market regained the importance of the early 1970s (see Table 2). From 1984 to 1990, Brazil lost more than one third of its share of the U.S. market, and the collapse has continued: in 1991 U.S. exports were less than 20 percent of Brazil's total exports.

Disaggregated figures showing shares of Brazilian imports to the United States (Table 3) indicate that the decreasing overall importance of Brazilian exports to the U.S. can be explained by the relative decline of food product exports to U.S. and, to a lesser extent (by a factor of about 10 relative to food), of manufactured goods excluding machinery. Food imports fell from 7.1 percent of total U.S. imports in 1984 to 5.75 percent in 1989. But Brazil also lost market share in the U.S., especially in food and live animals (SITC 0, which includes coffee and orange juice), which fell from 12.6 percent to 7 percent because of gradual dislocation of Brazilian coffee exports by those from other origins and fluctuations in the U.S. domestic production of orange juice.

A FTA with the United States would have consequences for Brazilian imports and domestic production of competitive products similar to those of multilateral liberalization. Since Brazil's tariff is high, and given the diversification in the origin of imports, trade diversion of other suppliers would be considerable. It is to be expected that suppliers such as the EC could, in retaliation, increase obstacles faced in its markets by Brazilian exports. It is also likely that relatively inefficiently produced imports from the U.S. would divert efficient producers if no other developed country had preferential access to the Brazilian market. Trade creation in Brazil would also be relatively more important since the tariff is higher than in the U.S. and adjustment costs related to the displacement of domestic producers by imports are likely to be substantial.[22]

21. See Erzan and Yeats (1992b), table 8.

22. See Fritsch (1989).

Table 2
Brazil's Exports to the United States, 1980-1990
(percent)

Year	Share of exports to the U.S. of total exports	Brazil's share of U.S. imports	Brazil's share of U.S. non-oil imports
1980	17.4	1.61	2.30
1984	28.4	2.38	2.93
1989	24.3	1.82	2.06
1990	24.5	1.66	1.88

Sources: Calculations based on IMF and Brazil Central Bank data

Table 3
Shares of Imports to the United States Originating in Brazil
in U.S. Total Imports, 1980-89
(percent)

	Share of Brazil's exports to the U.S. (1984)	Share of U.S. imports 1980	Share of U.S. imports 1984	Share of U.S. imports 1989
All food (STC 0+1+22+4)	31.2	10.73	10.9	6.19
Agricultural raw materials (2-(22+27+28))	1.9	2.79	2.91	3.8
Fuels (3)	9.7	0.06	1.27	0.36
Ores and metals (27+28+68)	5.3	1.51	3.52	3.27
Manufactured goods (5+6+7+8-68)	49.5	1.04	1.36	1.24
Chemical products (5)	5.5	1.49	3.16	1.57
Other manuf. products (6+8-68)	30.5	1.52	1.91	1.57
Machinery (7)	13.6	0.67	0.91	1.05
Memo: Iron and steel products	—	2.80	5.04	5.85
Textiles		3.45	3.79	3.21
Fruit juices	—	38.78	75.25	55.87

Source: Calculations based on United Nations Commodity Trade Statistics, 1989.

The importance of the Brazilian market cannot be underestimated, even if Brazil's mediocre macroeconomic performance since the early 1980s—high inflation and falling per capita GDP—contrasts painfully with the improvement of other Latin American economies. Brazil's is a relatively closed economy, partly because it is of continental size. Even so, its market for imports compared to those of other Latin American economies is second only to Mexico's (Table 4), in which the United States market share is already very high. Even if, for example, Chile's import/GNP ratio is five times Brazil's import/GNP ratio, the sheer size of Brazil's GNP, about 15 times that of Chile, means that Brazil's import market is roughly three times the size of the Chilean market. Moreover, the size of the domestic market is increasingly relevant, even with relatively low ratios of openness, for issues directly or indirectly related to foreign investment, services and intellectual property, tend to gain in importance compared to traditional trade issues.

Remaining outside either a "hub-and-spoke" trade integration of the Americas, or a WHFTA with many members, or without a preferential arrangement when most other Latin American countries have one, would foster potential trade conflicts with the United States. Brazil's exports are likely to be diverted by the United States in Latin America, given the high share of manufactured goods in exports to other Latin American countries and the share of Latin American exports in Brazil's total exports.

Alternative scenarios for the timing and scope of economic integration depend crucially on United States policy. One alternative is that while NAFTA is being digested, that is, while the political consequences of the initial dislocations produced by trade liberalization are being settled, the U.S. would not be eager to consider further concrete initiatives seeking integration with a relatively large Latin American economy such as Brazil, either through bilateral FTAs or NAFTA docking provisions. This will be true despite the significant advantages to the U.S. if its products benefit from preferential access to the Brazilian market. An additional independent deterrent to the U.S. is a continuation of the "sick man of Latin America" syndrome in Brazil.

Table 4
Openness and Size of the Largest Latin American Economies, 1990

	Exports/GNP	Imports/GNP	Total trade/GNP	Total GDP (Brazil = 100)
Argentina	0.138	0.046	0.184	22.2
Brazil	0.078	0.056	0.134	100.0
Chile	0.335	0.274	0.609	6.4
Colombia	0.166	0.137	0.303	10.1
Mexico	0.124	0.131	0.255	53.3
Peru	0.130	0.128	0.259	6.2
Venezuela	0.341	0.126	0.468	12.5

Source: Calculations based on World Bank data.

Moreover, given the similarities of economic structures in Brazil and Mexico, it is to be expected that Mexico may resist Brazil-United States preferential trade arrangements for fear of eroding previous benefits gained in the U.S. Integration sequencing is likely to be defined by resistance to widening integration by previously integrated partners.

The alternative scenario is determined by willingness of the United States to go ahead with WHFTA because its political significance and perceived economic gains outweigh difficulties caused by perceived costs related to domestic dislocations. Attention would tend naturally to center on Brazil, which will then face a difficult situation. Its interests are multilateral and systemic, and not strictly regional. To proceed with integration with the U.S. would further strain the domestic sectors that are already adjusting to a significant trade liberalization program. Tariff rates, however, are above those in other Latin American countries, and they will remain so after the last round of reductions in mid-1993. Trade diversion will significantly affect other suppliers with a risk of retaliation in the case of some of them, in particular the EC.

The fact that Argentina and Brazil are partners in MERCOSUR in principle fosters economic integration between Brazil and the United States, given Argentina's considerable enthusiasm for integration with the U.S. even if the economic foundations of that enthusiasm are somewhat mysterious. But there are powerful counterbalancing factors. The most important are linked to the lack of perceived net economic advantage for Brazil. The balance of costs and benefits is likely to be worsened by the potential dislocation of Brazilian exports by U.S. products in Argentina. Recognition of such difficulties has prompted Brazil to proceed on a "four plus one" basis, that is, MERCOSUR and the U.S., rather than bilaterally.

There are also political limits to Argentine initiatives that counter Brazil's concrete interests. Interest in the two big partners in MERCOSUR was from the start not symmetrical, given the size of their markets. Political arguments had great weight in explaining Brazil's stance. Argentina's recent increase in import duties to reduce trade imbalances generated by overvaluation of the exchange rate has been accompanied by criticism of Brazil's macroeconomic policies as a cause of the import surge. While Brazil's inability to control inflation is a major stumbling block in the path of MERCOSUR, this should not hide the substantial distortions in Argentina's foreign exchange policy. One of the very few acceptable features of economic policy in Brazil is that the exchange rate is about right. In Argentina itself, lobbies favoring integration with the United States, even at the cost of jettisoning MERCOSUR, seem to be gaining strength.

The consequences of regional arrangements such as NAFTA and WHFTA on investment flows will vary dramatically depending on specific conditions. It is reasonable to expect that investment from the United States would benefit larger countries such as Mexico and Brazil. It is also likely that, at least initially, the drive for economies of scale and scope will benefit those countries where there already exists a small number of large plants. This is especially relevant in the case of multinational enterprises. The theoretical increase of foreign investment from sources other than the U.S. could be reversed by clauses such as those on rules of origin. The stiff origin requirements defined for the automotive industry under NAFTA, for example, will further reduce Mexico's already limited attraction of investment by Japanese firms. But such general arguments must be qualified by consideration of comparative macroeconomic environments. Brazil's present capacity to attract such investments is limited despite its structural advantages of size.[23]

In principle, the enhancement of intraindustry trade as a consequence off regional integration depends to a great extent on the timing of inclusion of the bigger partners. So, the later Brazil and Argentina are integrated with the United States relative to the inclusion of Mexico in NAFTA, the more likely it is that inter- and intrafirm arrangements will consolidate intrasectoral trade within the respective regional integration arrangements. This affects present industrial capacity and future investment fostered by tariff reductions and improvement in operating conditions.

Relations Between Brazil and the United States and Regional Integration in the Americas

It is not easy to determine how relations between the United States and Brazil would be affected by the most likely outcomes for regional integration. Two scenarios based on different U.S. policies on the pace of regional integration have been considered. The first, with the U.S. unwilling to proceed very rapidly with trade integration with other Latin American economies, would generate less friction than the second, in which the U.S. pursues integration more actively: Brazil's diverse economic interests would make it unenthusiastic to pursue rapid integration.

But different trends concerning economic policy and structural reform in Brazil are highly relevant to any analysis of the future of economic relations between Brazil and the United States. On the other hand, it is not unlikely that trade liberalization will remain frozen or even be reversed in special cases. Other structural reforms such as privatization have already been adversely affected. One extremely serious (but frequently missed) consequence of the institutional crisis that led to President Collor's impeachment for corruption is that structural reforms introduced by the previous administration are being singled out, especially by vested interests, as being tainted because they were proposed by a discredited president.

In a climate of low expectations there is no credible role for strategic trade policies. Decision making would face well-known difficulties. The effects of costly past errors in targeting and pace, and sharp deterioration of administrative capacity in the federal government. It is unlikely that timid advances in political transparency will be able to compensate for these unfavorable trends. If this scenario prevails, Brazil's credibility will continue to reflect its economic fragility, and relations with the United States are likely to deteriorate.

Given the limits of Brazil's interest in economic integration, its stances and activities in multilateral trade forums, particularly in the GATT, are likely to be remain more important. There is some scope for convergence of interests with the United States in this context.

Brazil's negotiating agenda in the GATT emphasized issues related to Brazil as a *demandeur*: temperate agriculture; tropical products; textiles and clothing; antidumping duties, subsidy countervailing duties, and other impediments to exports of manufactures; and improvement of the GATT system including dispute settlement and definition of rules and their implementation. The rest of the agenda

23. See Vernon (1992), p. 25.

consisted of issues of a more defensive nature: "new issues" that have become traditional—services, TRIPS and TRIMS—and emerging themes that will become increasingly important in multilateral negotiations. These include the harmonization of policies related to environmental protection standards, competition, and labor rights, and to discrimination of third countries created by regional integration initiatives such as stringent rules of origin. There is concern that Brazil may become a preferred target of discriminatory actions by developed countries including the United States, as policy harmonization is required to ensure a "level playing field."

There is a convergence of the interests of Brazil and the United States in relation to agricultural liberalization and most systemic issues.[24] In relation to most other GATT "backlog" issues, the two countries are likely to have more difficulty finding common ground. Brazil is interested in improving access to the markets of developed countries including the U.S. In relation to the "new issues," and, still more, to the emerging issues related to policy harmonization, the potential for friction is considerable since the U.S. leads the group of *demandeur* countries.

Durable minimization of frictions between Brazil and the United States requires a combination of relatively slow hemispheric integration, a continuous commitment to multilateral liberalization by both countries in the GATT, and developments in Brazil that would assure achievement of price stabilization and the effective implementation of structural reforms progressing towards the consolidation of a market economy.

24. The asymmetric interests concerning the new issues, particularly TRIPS, combined with certain features of the proposed WTO, such as the integrated dispute settlement system allowing cross retaliation, could be unfavorable to developing countries. Similarly, the existence of several specialized councils may weaken the position of contracting parties with limited bargaining power.

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FROM MERCOSUR TO AMERICAN INTEGRATION

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Introduction

Brazil is going through an important moment in its international relations and foreign trade policies. It has to choose between two possible strategies. The first is the maintenance of multilateralism, which is the strategy Brazil has been following for a long time: no special relationships with those regional blocs that are being created, except for the Southern Cone. The second one is the strategy of American integration, i.e., the insertion of the Brazilian economy in a regional bloc led by the United States.

It may be necessary to rethink the question of inserting Brazil in the international economy, since the previous framework that has served as reference until now has been impaired. This framework, in its straight form, is not useful to the United States nor to Brazil. The alternative is to adopt new strategies, consistent with the new international realities.

Since 1991, Brazil, Argentina, Uruguay and Paraguay have been engaged in a process of economic integration that ought to be accomplished by the end of 1994. In spite of the difficulties of such a project, the countries belonging to MERCOSUR are aware the integration cannot exclude a strategy of international insertion, since MERCOSUR alone is not sufficiently large to bring to the member countries economies' the necessary dynamism.

The MERCOSUR option has already been adopted and is not under discussion here. Our point is to analyze the future options of alliances within a new international order. The fundamentally important decision to be made by Brazil and its partners of MERCOSUR refers to the selection of a strategy of insertion in the international economy.

One alternative is the maintenance of the strategy of multilateralism, where Brazil doesn't stand for special alliances with any other great partner or trading bloc and maintains its policy of export diversification by products and destinations. This option has been defended and implemented through the 1970s and 1980s.

Another alternative is to strengthen the alliance with the United States but not at the expense of our relationships with the rest of the world. Drawing on the 1990 proposal made by the United States the main objective is to create a free trade area in the region. Brazil would profit from the access to a big market, new investments and technology but, on the other hand, would run the costs of opening its economy, which is not fully prepared to face the competition of the United States, and the costs of imports diversion from other trade regions. On the other hand, Brazil would be buying an "insurance policy" against the uncertainties of the future, especially against possible problems brought about by the strengthening of regional blocs, including the North-American one; such as: selective protection to certain products, defense of the interests of the members of the bloc, and one-sided decisions against the alleged "unfair trade" practiced by exporters outside the bloc. These are the common practices of an international trade more and more managed and less and less liberalized in a world where there is no hegemonic power to ensure true multilateralism (Krasner 1976).

This paper will examine the Brazilian policy option of adhesion to WHFTA. The first section will analyze the new reference framework facing Brazil after the collapse of communism and the end of the Cold War. Then it will analyze the possible interests of the European Union, formerly the EC, and Japan in Brazil. In the third and fourth sections we will discuss respectively the national interest of the United States and of Brazil in the creation of an American bloc. The fifth section discusses Brazil's objections to the creation of a U.S.-led economic bloc.

The paper will adopt a historic or realistic approach. Theoretically, multilateralism is the most rational long term option for Brazil just as it is for any country in the world. In the short and medium run, however, Brazil has to analyze the international trade and investment tendencies, and consequently take initiatives, instead of being dragged by the circumstances or excluded from the emerging world economic system.

The New Framework

Several factors define the new framework. The slowing of economic growth of the developed countries, and particularly of the United States, after the first oil shock of 1993, the extraordinary success of Japan and the Asian tigers, the consolidation of the former EC, the democratic revolution in East Europe signalling the collapse of communism, and the debt and economic crisis of Latin America since the 1980s are some of the new historic facts that define an emerging new international order and make it necessary for Brazil to take a stand.

Four aspects of that changing process are particularly relevant to the definition of the new framework:

- *The change from a bipolar model to a multipolar one.* The New International Order defined in 1989 with the fall of the Berlin Wall, the reunification of Germany and the collapse of the Soviet Bloc, broke down the old model of power bipolarity between the United States and the USSR. With the end of the Cold War the world faces the lack of clear economic leadership and the birth of a new multipolar model, which will probably be centered on a triad composed of the EU, the United States and Japan, confronting other poles of political rather than economic power. Among them probably will be Russia, allied to what will be left from the Commonwealth of Independent States, the Muslim Group and even China, which is in the process of economic liberalization.

- *End of the U.S. hegemony.* The United States has already lost the leading position in world trade to the EU, both in exports and imports. They have also lost to Japan their technological leadership in some leading sectors, including those of mass production such as automobiles, informatics and telecommunications. The United States has changed from the position of foreign investment leadership to big international debtor, with a foreign debt amounting to over $1 trillion, an internal debt of about $4 trillion, a budget deficit around $300 billion and a trade deficit of about $100 billion. At present the leadership of the international economy is vacant but two other candidates besides the United States are in the race: the EU and Japan. As Japan is a great economic power but not a political one in the international arena, the former EC, now the European Union, is doubtless the strongest candidate for world leadership (Thurow 1992).

■ *Globalization of the economies.* The globalization of markets, production and investment puts an end to the old model of national economies centered on their domestic markets and gives priority to export activities, which have been growing faster than the internal ones. Such a globalization leads to the internationalization of trade, investments, and of the transference of product and process technology.

■ *Weakening of multilateralism and strengthening of regionalism.* The ever growing complexity of the international trade relations eventually upsets the basic principles supported by the General Agreement on Tariffs and Trade—GATT: trade liberalization and multilateral negotiations, involving the condemnation of all forms of discrimination between commercial partners. However, for the last few years the world has witnessed the strengthening of "managed trade," i.e. the selective protectionism related to special products and partners, the adoption of unilateral measures against unfair trade, and the creation of regional blocs. According to Primo Braga and Yeats, in 1988 the percentage of international trade based on regional agreements was 53.7, with 30.5% of this taking place within the EU or between the United States and Canada. The authors, however, after pointing out that the system of unilateral trade agreements has already reached irreversible proportions, conclude that "the proliferation of managed trade initiatives seems, to us, to pose a larger threat to the multilateral trade system in a post-Uruguay Round world than new preferential trading blocs" (1992:21).

Such trading blocs have their own typology: (a) economic bloc via common market, such as the EC; (b) trading bloc via a free trade agreement such as the NAFTA; and (c) blocs of concerted production, of the kind being developed between Japan and the countries of the Pacific. The last type targets the big foreign markets, but doesn't intend to create a free trading area among them.[1] As indicated by the difficulties being faced in the Uruguay Round, the ambitious attempt to strengthen GATT as the international trade ruler has been frustrated exactly because the international trading partners have already been practicing a pragmatic regionalism, opposed to the sort of a trade liberalism which nowadays appears unattainable.

Within this framework, new relationships are beginning to develop in the continent. They may become the embryo of American integration, with the creation of the Bloc of the Americas or the Americas' Free Trade Association. From World War II to the end of the 1970s the relations between the United States and the other countries of the Americas were marked by a process of conflict and cooperation. Conflict arose mostly due to the national import substitution industrialization strategy adopted by the Latin-American countries, while the cooperation came from the support given by the region to the United States in their confrontation with the USSR.

The 1980s were marked by conflicts of interest related to trade, to intellectual property rights, to the foreign debt and by the Latin-America's becoming aware of the necessity to face the fiscal crisis, at a time when the populist, inner-oriented growth strategy proved exhausted. There was no alternative but to implement market-oriented structural reforms and enforce fiscal discipline.

1. Sylvia Ostry proposes a typology of modes of integration based on its depth. We would have "deep integration", involving economic, political and institutional dimensions, as EC, and "economic or natural integration", as NAFTA and the East Asian bloc (1992: 5).

at a time when the populist, inner-oriented growth strategy proved exhausted. There was no alternative but to implement market-oriented structural reforms and enforce fiscal discipline.

The 1990s will probably be marked by new threats, now related to economic and social themes such as: drugs, immigration control and environmental protection. The key-point of the new relationship, however, is the reduction and consolidation of Latin-America's foreign debt, the success of the stabilization programs and structural reforms and, above all, the efforts to resume growth and income distribution, which are not yet assured.

Having in mind this last objective, the United States, through the Enterprise for the Americas, put forward an initial proposal for creating an American Free Trading Zone granting the Latin-American countries access to their market. Regardless of its intrinsic merits, President Bush's proposal differs from the other two emerging blocs (the EU and the Japanese) because they do not show the same interest in Latin America.

The Priorities of the EU

In the late 1980s, Brazil and Latin America expected that the then EC would considerably change its attitude toward the region with the entry of Portugal and Spain into the Community. But, in spite of new cooperation agreements (already in the third generation) which include a vast repertoire of initiatives, the essential elements such as access to markets and investments or financing have not changed. Brazil's only privilege is the access to the Generalized System of Preferences. But because it is one of the greatest beneficiaries of that system, Brazil runs the risk of having many of its products excluded from the next program now being negotiated. It is true that the volume of resources for financing and support has risen, but they are mainly addressed to the least developed countries of the region, especially Central America.

In the late 1980s the Commission in Brussels tried to turn the foreign debt into a political issue but was told by its members that this was a prerogative of the individual governments, rather than a Community's concern. Additionally, the members of the EU followed the leadership of the U.S. government and of the U.S. commercial banks, which are the greatest holders of Latin-American debt.

From 1986 on, the EU reappears in the international scene as a great economic power by converting the internal market into reality with a free flow of people, goods, services, and capital. It thus became an important partner not only because of the size of its market but also because of the possibilities of accomplishing new agreements on commercial cooperation, investment and technology. Yet, the EU now faces great challenges: the deepening of the Community with the establishment of the monetary and political unification negotiated in Maastricht in 1991; enlargement of the Community with the adhesion of new members such as Austria, Sweden, Finland, Switzerland and Norway, the next plus the adhesion of Central European countries, such as Hungary, Poland and perhaps the Czech and Slovak Republics within the next five or seven years; adoption of a security policy to protect its boundaries against massive immigration, drug traffic, organized crime, besides actual threats such as terrorism, political fanaticism arising from the growing of the ultra-conservative right wing and the religious problems arising from the spread of Muslim fundamentalism inside and outside its boundaries; and, above all, the revival of old ethnic rivalries putting in check the whole concept of the nation-state in which the construction of Europe is based.

On the other hand, the EU established, during the last few years, a system of trading preferences and economic concessions aimed at the creation of an enlarged economic bloc under its influence.

Within this framework it is hard to believe that the EU conceded to Latin America something more than political agreements, full of good intentions but lacking economic content.

The same is true of Japan. Its interest in Latin America and specifically in Brazil is only marginal. Japan showed some interest in Brazil in the 1970s, as long as Brazil seemed to complement its shortage of natural resources. But since the crisis of the 1980s its lack of interest has become almost aggressive. Even when they are vigorously competing among them, one of the characteristics of Japanese business enterprises is the solidarity they exhibit in their international performance. Through an invisible coordination, that may originate in the government or in the trade associations, the decision whether to invest or not in a given country or region becomes common to almost all the enterprises. At the regional level, Japan's investment decisions seem to have concentrated in the South-East and East Asia. Japan's' interest in Latin America is distant. Japanese government officials and business men usually say that "Latin America is an area of influence of the United States".

The National Interest of the United States

The attitude of the United States towards Latin America is different from the aforementioned. Before examining this subject, let's scan the United States trading policy, which has developed in three different levels (Preeg 1992).

At the internal level, the U.S. trading policy may be characterized as one of selective protectionism in response to pressures from non-competitive industrial sectors. Among the protected sectors are the automotive, electronic, computer, steel and textile industries. Another characteristic is the unilateralism against any measure considered unfair to the United States trade which leads to immediate retaliation even going against GATT's principles (Section 301, Super 301 and 301 Special).

At the multilateral level, the United States was most interested in launching the GATT's Uruguay Round in 1986. The U.S. was also responsible for the inclusion of new sectors in the negotiations such as farm goods, textiles, services, intellectual property and investments.

At the regional level, the United States led the process of creation of the NAFTA, aimed at the creation of a zone of free trade not only with Canada (since 1989) but also with Mexico (1994). NAFTA was initiated by Mexico, but it is clearly a new political option for the United States in face of the reality of the new trading blocs.

It is not the right time to discuss whether free trade areas are mainly trade diverting or trade creating. Since these two possibilities were defined in the 1950s by Jacob Viner, who opted for the first one and, thus, opposed regionalism, this issue has been subject to debate. Regional blocs, in the form of free trade zones or custom unions, are authorized by article XXIV of the GATT. Thus, an exception was established to the basic principle of non-discrimination (the most favored nation clause), as long as the constitution of the new bloc doesn't entail higher barriers to trade with the rest of the world and as long as the tariffs, within the bloc, tend to be around zero. This article has been discussed ever since, particularly in relation to the EU, the most successful case of regionalism.

Though having approved article XXIV, the United States has always been in favor of multilateralism. They supported the constitution of the European bloc for political reasons mainly. But there was a clear change of attitude. As Krasner notes, "the end of the Cold War does mean that the United States will become increasingly economically self-interested in its international economic policies. It will no longer be as strongly committed to multilateralism. This will make regional blocs more attractive" (1991: 340).

In this context, despite the resistance inside the United States and the criticism of liberal economists such as Baghwati, who considers the existence of bloc as a clear threat to free international trade (1992), the general tendency in the United States is to support regional agreements. Since the first best scenario-multilateralism-is not currently a viable option, the tendency today in the United States is to believe that FTAs do not conflict with the broader and longer term perspective that favors multilateralism (Dornbusch, 1991; Hufbauer and Schott, 1992).

But regionalism is still marginal to the United States which, as a matter of fact, maintains an aggressive policy for the maintenance of their most important markets (EU) and for opening new markets (Japan). They also concentrate their foreign investments in those markets. Every time a national sector feels that it has been harmed by the so called unfair trade practices, the United States react violently against the "aggressor", putting aside political speeches and acting in a unilateral way.

The United States' proposal for the initiation of an American bloc originated from two important perceptions. The first one was the necessity of a policy that ensured them broader markets than Canada and Mexico in case of failure of the Uruguay Round and weakening of GATT as moderator and supervisor of the international trade. The United States aims to balance the specific weight of the EU, shored up by the bloc of its satellite countries, and that of Japan, strengthened by its production-bloc in East and South-west Asia, with the bloc led by the United States: a bloc that could be called the Bloc of the Americas or Americas' Free Trade Association.

The U.S. seems to have already decided that their national interest coincides with the creation of the NAFTA. However, it is not clear to them if it is worth widening the bloc to include other countries of the hemisphere. The interest of the United States underlying a WHFTA could be classified in two types: rhetorical and real interests.

The rhetorical interests had immediate political objectives, justifying regional integration as an element of pressure from the United States against the strengthening of the EU and Japan. On the other hand, the possibility of creating an American free trade area would become a weapon for the United States against the European countries that have been insisting on the protection of their agriculture, causing the Uruguay Round to stall. So, if trade liberalization and multilateralism fail to progress, the United States would be assured by signing free trade areas with strategic countries: Israel (1985), Canada (1989), Mexico (1993) and maybe all the Americas in a near future. But the arguments of the Bloc of the Americas against the Eurobloc in the GATT negotiations were invalidated by the alliances of the United States with the Group of Cairns of agricultural producers such as Australia, New Zealand, Argentina and Brazil, that constituted another pressure group against the then EC.

However, besides the rhetorical interests, used only as elements of impact in international negotiations, there are real interests that justify an alliance between the United States and Latin America, specially with Brazil.

Among the real interests of the United States in an integration with Latin America we may point out:

▪ *Impossibility of dominating all of the Third World markets.* The United States is beginning to realize that it is no longer the sole world power. For the great power, that it was in the bipolar model, the defense of multilateralism and of trade liberalization were the most rewarding strategy. But reality has changed. As hegemonic leader of the western world, the United States dictated the rules of the international game and held privileged positions in many markets. Today this world leadership is contested by the EU and Japan, since they have established their influence areas. So, the EU leads Northern Europe, Eastern Europe (except CIS, the Commonwealth of Independent States), Northern Africa and Sub-Saharan Africa. Japan has become stronger in Western and South Western Asia including China. The United States still holds a dominant position in North America, the Middle East and, historically, in Latin America.

The Islamic Group concentrates great influence in the Muslim countries of the southern CIS, in the Middle East and in Northern Africa. Its current behavior is hardly foreseeable. As a matter of fact, Islamic fundamentalism is meant to be an alternative to the capitalist and to the communist world. In this area the American influence will face severe restrictions in the future.

Within the present framework the United States' leadership in Latin America will not be contested by the other world leaders, the EU and Japan, which are involved in the consolidation of their own areas of influence.

▪ *Interest in managing the debt problem.* The great debate of the 1980s was the various attempts to solve the Third World debt problem. For the United States, the Latin America debt ($420 billion) was the most important. Most of the debt is owed to private American banks and the continuity of a flow of payments depends on the generation of foreign currency through exports. The certainty of accessing the American market may be an important point in managing this problem.[2]

▪ *Need for a new dialogue between the United States and Latin America.* Since the security problem of the Americas has been lessened by the collapse of the Soviet world, the United States needs another argument to base its dialogue with Latin America. Thus, the Enterprise for the Americas proposed under the Bush administration relaunched the economic dialogue with Latin America in the 1990s. Now we have the priority of the economic over the political and an attempt to manage the new threats and conflicts between the two regions. The United States is like an actor without a script before a marginalized Latin America. New interest must be created to bring them near again.

▪ *Commercial interest.* The creation of the trading bloc led by the United States is a real rather than a rhetorical necessity and was born from the uncertainties surrounding the world of today. The United States has been the most important partner of Latin America as a whole (as for Brazil it comes

2. As Bhagwati points out, "the offer in June 1990 by President Bush to get more nations from South America to join the United States in a free trade area... is reflective of the compulsions that the debt crisis there imposes on American policy to respond in a regional framework to ensure that this crisis remains manageable and does not engulf the United States, whose banks are principally endangered by it" (1992: 15).

second, after the EU). Even so, its exports to Latin America have been falling every year. It is important for the United States to regain a comfortable position.

In spite of these arguments, some analysts, like Andrew Hurrell, maintain that "there is no clear impetus nor incontrovertible political or economic logic behind the arguments that the United States should seek to create or reestablish a new regional order in the Americas". Besides this, Hurrell doubts that the United States has the power to do that, adding: "And there are also real questions as to whether the U.S. has the economic resources to do so".(1991: 39). Yet, the facts are demonstrating that this analysis does not correspond to reality. NAFTA is already a reality. The loss of hegemony of the United States is basic logic behind this new position of the United States.

After several interviews with businessmen and U.S. government officials, Roberto Bouzas and Juan Carlos Barbosa concluded that the negotiation of a free trading zone with MERCOSUR is still considered premature. The agreement with Mexico has to be concluded first. But they showed great interest in the Southern Cone and particularly in Brazil, "characterized as an interesting partner of the United States not only because its economy has great potential, but also because it represents wide perspectives of expanding U.S. exports since the Brazilian economy remains relatively closed". On the other hand, "the potential for expansion (of Brazil) if the American business installed in Brazil reorient their production from the domestic market to export" (1992:44-45).

In short, with the end of the Cold War and of the hegemony of the United States, there remains the possibility of the strengthening of regional blocs. The United States, though not yet resigned to the loss of hegemony and naturally eager to maintain its trade open with all the world, will have no choice but to support the Bloc of the Americas. This bloc will be very useful to the United States not only to exert pressures and bargain positions in the international context but also to assure for its exports and investments a preferential space.

Brazil's National Interest

Given this new political fact rooted in the movement toward American integration, one has to ask the question: what is Brazil's national interest? Should we accept such a proposal or not? After all, unless the economic agents in Brazil are really interested, no agreement will work.

The true interests of Brazil in American integration derive from the country becoming conscious that the old international order, which supported its multilateral strategy, is over. In the new international order requires a new strategy for Brazil's insertion in the world economy. Actually the new interests are shared by Brazil, MERCOSUR and Latin America as a whole.

Some international changes justify Brazil's new national interest. First of all, we have the failure of Brazil as a model Third World power and leader of the non-aligned countries, outside of the domain of the United States and of the former USSR. This model was exhausted by the foreign debt crisis and the end of the strategy of import substitution. Such strategy of nationalist character, which reached its peak in the 1970s, didn't prove itself a realistic alternative capable of promoting the development of

Brazil in the 1980s. Instead of pressuring the First World to obtain preferential treatment,[3] we had no choice but adopting a defensive position before the pressure of our creditors. At the same time, we had to admit the mistakes of economic policy caused by the fact that the import substitution strategy was artificially extended in the 1970s through external financing. The ideas of reducing the state through trade liberalization, deregulation and privatization became dominant, putting an end to Brazil's Third World oriented strategy.

Second, we have the crisis of the state. Since the 1930s, the state has been the major agent of Brazil's economic development, through three instruments: (1) the import substitution strategy, which gave a big impulse to the industrial expansion of some Latin-American countries; (2) subsidies to the industrial sectors considered as strategic; and (3) direct investment in state-owned enterprises. This strategy, however, was already exhausted in the early 1960s. It was artificially maintained in the 1970s through foreign indebtedness to finance projects of import substitution, as well as by a new wave of subsidies and the creation of state-owned enterprises. But the cost of such an option turned out to be very high after all. It resulted in a deep crisis of the state that has two components: (a) a fiscal crisis directly related to the foreign debt, which financed excessive state expenditures and resulted in a extremely high public debt, the decrease of public savings (which became negative after all), and to a vanishing public credit: and (b) the exhaustion of the model of state intervention based on the import substitution strategy.

The crisis of the state in Brazil is the fundamental cause of the high rates of inflation that devastate the country, the decrease of investments and economic stagnation. In the last 12 years Brazil has been facing the most serious economic crisis of its history. It is clear that the present decade and the new international framework call for radical changes. Brazil has to define a new national project of development and internationalize its economy at the same time.

The process of internalization of an economy does not signify, as Washington and the "First World" usually believe, just to stabilize prices, reduce the state, and open the economy. These are necessary but not sufficient conditions. The neoliberal strategy assumes that the rise in investment, which is absolutely essential to the resumption of development, will come from abroad, from the multinational enterprises. This assumption is not realistic. It is possible and desirable to expect an increase in foreign investment but we know that there are clear limitations to that kind of source. The great changes in the international framework have moved the poles of political and economic concern to other regions of the world. The new priority areas in terms of commercial promotion and new investments became: the EU with the consolidation of its internal market in 1992, the countries of Central Europe, which are now under the influence of the EU and may serve as an outlet for EU exports; the countries of the Pacific Basin Area, due to their high rates of growth; and Mexico, which has negotiated its participation in the NAFTA. Besides the change of poles of political and economic attraction, the figures confirm the marginalization of Latin America in international trade. In 1950 it represented 11% of the world exports, in 1958 about 5% and in 1990 only about 3%.

The definition of a new national project involves, first of all, the recovery of the saving capacity of the state. This would be done through an increase in revenues, decrease of current expenditure or through the cancellation or consolidation of its public debt (whose respective interests reduce public

3. This was the leitmotif of the "new international order" strategy that the non-aligned countries adopted in the 1970s.

savings). On the other hand, it has to open the economy so as to guarantee greater external competition and more efficient resource allocation. Additionally, it has to stimulate the entry of technology necessary to modernize the industry and make it compatible with the philosophy of market and production globalization. These policies, complemented by competent industrial and technological policies, both financed by the recovered public savings, will constitute the basis for an aggressive posture in the exporting business, necessary to stimulate internal investment and generate positive balances of foreign currency.

Based on this framework, let us examine Brazil's foreign trade policy. In the last years it has been developing within three different dimensions (Azambuja, 1991). At the internal level, a policy of trade liberalization emerges, with a significant decrease in Brazilian tariffs up to the end of 1993. At the regional level, Brazil is actively committed to the creation of a common market encompassing goods and services with Argentina, Paraguay and Uruguay. This project might be accomplished by 1995. At the multilateral level, Brazil had a relevant role in the GATT negotiations of the Uruguay Round. Brazil defends the theses of nondiscrimination and lately of international trade liberalization. Some points of the negotiation that drags on in Geneva are specially significant to the country: agriculture, textiles, intellectual property and services. A fourth dimension will open up if Brazil decides to contribute more actively to the creation of the Bloc of the Americas.

In the late 1980s Brazil realized that the import substitution strategy was exhausted and that the most efficient allocation of its resources would depend on the opening of its markets and also that the resuming of development should be based on the aggressiveness of its exports. This perception added to the burden of the foreign debt and the pressure from multilateral agencies for the adoption of structural reforms led Brazil to start opening its economy.

In the last years, the flow of trade in global values demonstrated that Brazil's most important partners are the EC, the United States/Canada and ALADI. The figures of the destination of Brazilian exports in 1991 are: EU 31%, United States/Canada 21.5%, and ALADI 15%. Exports to the United States/Canada led the list up to 1988 but in 1989 the EU came first. The figures for 1990 were 32.3% to the EC, 25.8% to the United States/Canada and 10.2% to ALADI. What happened in 1991 is that the exports moved from the United States/Canada to ALADI, as the following table demonstrates.

Table 1. Brazil: Exports by Economic Zones (%)

	1988	1989	1990	1991
ALADI	11.0	10.2	10.2	15.5
US + Canada	29.3	26.6	25.8	21.5
EC	28.7	30.6	31.4	31.0
Japan	6.9	7.1	7.5	8.2
Asia	8.2	9.3	9.5	9.8
Middle East	4.4	3.5	3.4	3.5
Others	11.4	12.8	12.2	10.1

Source: Decex.

The flow of exports to the main partners, however, makes one important characteristic evident. The content of the exports to the EU in 1990 was 43% of manufactures against 57% of raw-materials and semi-industrialized goods. As to the exports to the United States and Canada, 76% were manufactures against 24% of raw-materials and semi-industrialized goods. Thus, the flow to the United States shows more variety and has a higher level of industrialization. (See Table 2).

Table 2. Brazil: Exports of Manufactures by Economic Zones
(percent)

	1988	1989	1990
ALADI	84.2	84.0	86.7
US + Canada	74.4	76.6	75.8
EC	39.1	38.9	42.7
Japan	25.3	19.6	16.6
Asia	61.6	43.6	41.8
Middle East	60.1	62.4	53.6
Others	4.1	44.6	43.3

Source: Decex.

Furthermore, analysis of the former EC as an economic bloc reveals a system of preferences within its trade policy that involves big alliances and high-level privileges with the EFTA, Central Europe countries, and Mediterranean countries. A more detailed analysis of such agreements and of Brazilian exports demonstrates that many products will be seriously affected in the near future. Among them: iron, ingots and steel, as well as product such as meat and vegetable oil, textile and shoes, auto-parts, paper and cardboard.

It is also important to remember that the most important partner for the rest of Latin America is the United States, whereas for Brazil the main market is the EU.

As to the Generalized System of Preferences, Brazil has access to the EU as well as to the United States through it. This system allows Brazil to export a range of goods with tariff reduction or exemption within given quotas. However, it is widely known that both the United States and the EU are willing to limit to the less developed countries access to that system. This would affect badly Brazilian exports to those markets.

Thus, in spite of the EU's being currently the most important commercial partner of Brazil, the United States represents some advantages: Brazilian exports to the United States and Canada have higher aggregate value, are more diversified and include products less prone to be affected by special agreements. Among the products Brazil exports to the United States are: aircraft, machines, transportation equipment, automobile parts, shoes and chemicals. The main products exported to the EU are: orange juice, soy bean complex, sugar, coffee, steel and iron.

On the other hand, Brazil and Latin America will have to compete with the Mexican products for the markets of the United States and Canada after NAFTA. With the tariff dismantling between the members of NAFTA, Brazil will have to face a competitor, with strategic advantages of proximity and zero-tariffs, competing for the same final markets. The present trend in the formation of regional blocs of international trade has created new practices for international relationships. One of them is the rule of increasing preferences for the members of the bloc even if this contradict the most important principle of GATT, nondiscrimination. The other is the rule of selective protectionism of the members of the bloc against outsiders, through the practice of managed trade to avoid further retaliation (for example, automobiles, electronics, steel, and textiles). In this framework, it is clear that Brazil has a lot to lose with NAFTA. Trade between Brazil and the United States would divert to Mexico due to the fact that nontariff barriers will be eliminated for Mexico but not for Brazil.[4]

As a matter of fact, Brazil and Latin America are marginalized in the international scene. The creation of MERCOSUR was fundamental and is doing very well. But it is not enough to generate the economic dynamism to take Latin America out of the present stagnation. In a marketplace full of antagonism and rivalries between blocs, such marginalization may be fatal.

The Counter-Arguments

The analysis just presented drives to the conclusion that Brazil ought to show great interest in the formation of the Bloc of the Americas. But this is not the official position of the Brazilian Ministry of International Affairs (Itamaraty) and of the most important economists who analyze our international relations.

For some time Brazilian diplomacy avoided the question of U.S. proposals for a hemispheric bloc, arguing that it lacked content. Brazil should wait for a clearer definition, namely, the United States was not really interested in a FTA with Brazil and the other countries of South America. Also, regionalism was not a real trend in the world. When this type of reasoning proved unrealistic, more explicit argument against Brazil participating of a FTA with the United States was developed.

The first argument was that the conditions that the United States established for Brazil and the other MERCOSUR members to join NAFTA were too demanding or just undesirable (macroeconomic stability, adoption of market oriented reforms, including an intellectual property agreement and protection of foreign investment agreement). As a matter of fact, macroeconomic stability, market oriented reforms and the protection of foreign investment are as much an interest to Brazil as they are of the United States. Only the protection of intellectual property is not in this case. Is much more on the interest of the United States, but in a bargaining process Brazil may gain accepting an agreement on that subject.

As a matter of fact, the Brazilian government understands that Brazil has an essentially multilateral vocation and no interest in participating in regional agreements in the continent. Only

4. Estimates given by the World Bank and referred to by Sérgio Abreu and Lima Florêncio (1992: 11) show that Brazil's gain with the elimination of tariffs and nontariff barriers could amount to some $0.9 million a year, which is only lower than Mexico's gain in the same situation ($1.6 billion).

MERCOSUR is viewed as acceptable. The argument that supports their position is extremely simple. Brazil is a "global trader", whose exports are widely diversified in terms of destinations. The United States accounts for only one quarter of Brazilian exports but is responsible for almost three quarters of the Mexican exports. Then, it would make no sense for Brazil to concede preferences to the United States.

Other arguments are added. Winston Fritsch enumerates two: first, within MERCOSUR, Brazil would lose out on reducing trade barriers relative to the United States; second, since the United States is not the most efficient supplier of Brazil's imports, the gains derived from bilateral liberalization would be smaller than those from multilateral liberalization. Fritsch, however, admits a rationale for Brazil: "the only economic rationale for a Brazilian interest in hemispheric integration is to gain discriminatory access to the larger US market." But he added immediately (adopting the "wait-and-see" attitude that dominates the present Brazilian policy), "the evaluation of such prospective gains cannot be made..." We will only know after "the Uruguay Round... the credibility of the US offer of free market access... and the negotiations involving Mexico and, perhaps, Chile, whose outcomes are still to be seen." (1992: 4)

An argument that reveals Brazil's fear of opening its economy to the United States is elegantly presented by Hélio Jaguaribe (1991). According to him, we have two models of integration: "factors redistribution model" and "systems restructuring model." The first one is claimed to be typical of small countries; the second one would be applicable to Brazil. According to this view, trade liberalization and the American integration should be conditional to technology transfer and managerial training in Brazil. The assumption behind is that the Brazilian industry has no capacity to compete with the American industry, requiring new forms of protection. If this is not done, Brazil will regress to being an agricultural country with a few and limited industrial activities.

In fact, this pessimism about the Brazilian industry is not realistic. No doubt, and in contradiction to the Washington consensus, it is necessary to have an industrial, technological, and managerial development policy. But one thing is to favor industrial policy, another is to have it as a necessary condition for a NAFTA with the United States. This is the best way to, *de facto*, oppose the American integration.[5]

Brazilian diplomacy is becoming aware that the United States are inclined to create a WHFTA after the creation of the NAFTA. This awareness is reflected in a recent and very representative text by Sérgio de Abreu and Lima Florêncio who admitted that "in the medium term we must be prepared to a possible association with an WHFTA" but "this should not be a priority of our international trade policy" (1991:10). As a matter of fact, the Brazilian positioning against the WHFTA is marked by

5. In a similar form, the strategy some Brazilian industrialists found to oppose trade liberalization is to make it conditional to the adoption of industrial policy. In a recent document IEDI, Instituto de Economia e Desenvolvimento Industrial (an institute formed by the most important national industries in Brazil) affirms the dilemma between protectionism and foreign opening is false. The opening to international competition is a required tool of modernization, since it prevents accommodation and immobilism. But its width and rhythm must be coordinated with the recovery of macroeconomic control, with a coordinated action on the systemic factors assuring competitiveness, and with industrial policies implying the reorganization of the productive system and aiming the persistent advancement of productivity" (1992: 2).

caution. Brazilian commercial relationships with the United States were very conflictive in the 1980s;[6] even more than with the EU and Japan, because both protected themselves against the increasing competition of Brazilian exports of manufactures, while the United States, attached to the principles of free trade, was constrained to make use of unilateral measures. On the other hand, Brazil has a long tradition of fearing the "imperialism" of the United States and trying to protect itself. The import substitution strategy and the Third-World oriented policy that Itamaraty has been competently adopting for many years has been a form of protection against imperialism. It is then very difficult for Brazil to accept quickly the hypotheses of further integration with the United States.

However, as the imperialist thesis is out of date, the alternative of its opponents is to disqualify the American proposal. This is done either by denying that there is a tendency to the formation of commercial blocs, or by the adoption of some standard phrases as "the proposal is not clear," "the Bush initiative lacks content," and "let's wait and see what happens."[7]

The argument that there is no tendency towards the formation of trade blocs was absolutely dominant in the Itamaraty until very recently.[8] With the increasing consolidation of NAFTA this thesis obviously is losing ground.

Thus, other forms of opposition to a WHFTA are emerging. An interesting one has been adopted by Santos Neves (1991), who argues that the creation of the NAFTA, whose rules do not include any clause about the access of the rest of Latin America, shows the United States' decision to marginalize South America. With the end of the Cold War, the Second and the Third World disappear. There are now four blocs: the European, the Japanese, the North-American and the one to be constituted around Russia. Thus "the South is not a fifth bloc, not even a lesser bloc. The people and nations of the South are simply those who have not found a place in the emerging international order, an order that seems to be guided by a harsh 'principle of exclusion'"(1992:5).

In this framework, Santo Neves continues, the NAFTA represents a historical watershed; the end of the economic concept of Latin America leading back to the geographical concept of South America: "the creation of the North American Free Trade Association brings to the fore the fact that

6. See Primo Braga and Silber (1988).

7. This attitude, however, seems to be changing. According to daily Gazeta Mercantil (8/22/92) in a seminar carried out at Fundação Getúlio Vargas, Rio de Janeiro, on August 21 (when this paper was almost finished), "for the first time since the announcement of the creation of the NAFTA, Itamaraty officially admits that the Brazilian competitiveness in the U.S. market is going to be harmed by the concession given to Mexico in the access to high tariff products and to protected fields like citrus, textiles and tile. This assertion was made by the Minister of International Affairs, Celso Lafer, in his speech".

8. See, for instance, Celso Luiz Nunes Amorim, head of the Economic Department of Itamaraty, argues that only the EC would effectively be a commercial bloc (1991).

the Latin American idea, although plentiful in historical substance, has lost a large measure of its economic and political thrust."[9]

Brazil and South America are, then, threatened with exclusion. But this doesn't drive Santos Neves to the conclusion that we must strive for integration into the Bloc of the Americas, while remaining faithful to multilateralism. We are supposedly excluded from NAFTA or from a FTA with the United States—an exclusion that Santos Neves does not regret, since he also opposes an integration with the United States. Our only choice would be to keep fighting for multilateralism. In line with the Brazilian policy, "Brazil aggressively opposes all forms of regionalized protectionism. All blocs must be open to international trade." (1992:17)

Santos Neves makes an intelligent and creative analysis that is representative of Brazilian thought, in spite of the author's warning in a footnote that his ideas "should not be construed to represent, in whole or in part, the official position of the government of the Federal Republic of Brazil." No doubt, the Brazilian official position is more moderate and more diplomatic. But it opposes a decisive adhesion of Brazil to the Bloc of the Americas.

It is probably clear by now that the Brazilian position is fundamentally contradictory. On one hand, it's admitted that there is a strong tendency towards regionalism. In addition, it is admitted that this regionalism may represent the exclusion of Brazil and Latin America from international trade and capital flows. On the other hand, Brazil insists in fighting against all kinds of regionalism, in favor of multilateralism as if it were easier to fight against regionalism than against the difficulties in integrating the Americas.

This position is obviously unrealistic. It shows an unacceptable geographical determinism. Chile is also part of South America but it is already in line to be included in NAFTA. Furthermore, such position reflects an old distrust relative to the United States that makes no sense today. It is not that our national interests coincide with those of the United States. We still have many conflicts. The point is that Brazil is no longer such a weak country that can not negotiate its own interests.6.

Conclusions: Insurance Against the Uncertainties of the Future

Multilateralism remains the ideal to be sought. But in the short or medium range there is no room in the world for multilateralism. The blocs are fully constituted, and they will not be an obstacle to future multilateralism. We either seek to be included, or we will be *really* excluded.

In this case, we cannot assume a cautious waiting position. It makes no sense to keep waiting for the United States to take the initiative or to further explain what they intend with a WHFTA. Brazil is big and mature enough to adopt an active position on this issue and help to construct the Bloc of the Americas. No doubt the United States is and will be the leader, and will hesitate about admitting Brazil.

9. The Latin America concept is historically new for Brazil. Up to the first part of this century Brazilians used to define themselves as South-Americans. The idea that we are Latin Americans was introduced by the United States, and some old nationalists never accepted it. The participation of Mexico in NAFTA is being viewed by these nationalists as a confirmation that Brazil is indeed part of South America, not of Latin America.

As it is hesitating in relation to Mexico. The differences in degree of development between the United States and Canada on one side and Latin America on the other, represent the main obstacle to integration. But since the integration responds to the national interests of the United States as well as to those of Brazil, there is no reason for its not being accomplished.

The foreign trade of the then EC, the United States and Japan in 1991, (taking into account intra-Community trade), represented 58% of world trade. Excluding the intra-EC trade, that figure falls to 35%. These data makes clear the weight of these powers in the international scene. Even though each one of them is trying to create and strengthen its own zones of influence and of preferential trade, none of them can afford to lose the major markets. Thus, Latin America's becoming a preferential partner does not mean any change in the American position in international trade.

To the United States the most important outcome of the creation of an American bloc is that it would provide an institutional framework to give support to several economic interests such as access to the Latin American market, regulation of investments and protection to intellectual property. Besides, it would provide institutional support to the solution of serious economic problems such as clandestine migration, drug traffic, and environment protection.

The major advantage for Brazil and for the whole of Latin America would be the end of the marginalization and isolation they have been suffering, especially in face of the context of uncertainties of the new international order. In terms of exports, Brazil doesn't need to negotiate privileged access to primary or semi-industrialized goods, since it is competitive enough to gain market share. So, with the EU the determinant strategy is efficiency. As to manufactures, the experience has demonstrated that international trade is becoming increasingly managed. For this reason, the negotiation of a zone of free trade, in the short term, may be a decisive strategy for the United States. To Brazil, a regional trading bloc proposed by the U.S. represents an insurance policy against the perplexities and uncertainties of a world of rivalries between blocs and lack of hegemonic economic leadership. The United States launched the proposal. It is up to Brazil either to let it die or to give it real content. The bet with the future may be on an occasional isolation of Brazil; maybe Brazil is compelled to join a bloc already composed by the main countries of Latin America; or maybe Brazil could be leading the interests of South America in the Bloc of the Americas centered on the United States.

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STATISTICAL APPENDIX

Table 3: Brazil: Exports per Economic Zones ($ billion)

	1988	1989	1990	1991
ALADI	3.7	3.5	3.2	4.9
US + Canada	9.9	9.2	8.1	6.8
EC	9.7	10.5	9.9	9.8
Japan	2.3	2.4	2.3	2.6
Asia	2.8	3.2	3.0	3.1
Middle East	1.5	1.2	1.1	1.1
Others	3.8	4.4	3.8	3.2
Total	33.8	34.4	31.4	31.6

Source: Decex.

Table 4: U.S. Imports ($ billion)

	1985	1990
World	358.9	515.6
Canada	67.9	93.2
Japan	72.4	93.1
EC	71.4	95.4
Latin America	48.3	66.7
Mexico	19.3	30.8
Brazil	8.1	8.6
Argentina	1.2	1.7
Chile	0.8	1.5
Venezuela	6.8	9.9
Colombia	1.5	3.4
Ecuador	2.0	1.5
Peru	1.1	0.8
% Imp.LA/total imports	13.5	12.9
% Imp.LA/Mexico/total imp.	8.1	7.0
% Imp.Brazil/Total imp.	2.3	1.7

Source: OECD - Organization for Economic Co-operation and Development.

Table 5: Exports to the United States ($ billion)

	1985	1990
World	205.2	371.5
Canada	67.9	93.2
Japan	73.4	93.1
EC	71.4	95.4
Latin America	29.5	52.2
Mexico	12.8	27.4
Brazil	3.1	4.9
Argentina	0.7	1.1
Chile	0.7	1.6
Venezuela	3.1	3.0
Colombia	1.5	2.0
Ecuador	0.6	0.7
Peru	0.5	0.8
% LA imp./totals imp.	14.4	14.1
% LA imp.- Mexico/total imp.	8.1	6.7
% Brazil imp./total imp.	1.5	1.3

Source: OECD.

Table 6: Economic Community's Imports ($ billion)

	1985	1990	1991
World	308.9	587.6	607.6
EFTA	62.3	137.9	136.2
US/Canada	58.1	120.1	125.2
Japan	21.7	58.7	63.7
ACP (69)	23.2	25.5	23.5
Mediterranean countries	33.7	53.7	53.5
Latin America	22.7	32.3	31.9
Brazil	8.0	11.7	11.6
Mexico	3.9	3.7	3.8
Colombia	1.3	1.9	2.1
Venezuela	3.0	2.3	2.0
Chile	1.4	3.3	3.1
Argentina	2.5	4.4	4.7
Uruguay	0.2	0.8	0.5
Peru	0.8	1.0	1.0
Ecuador	0.2	0.5	0.7
Bolivia	0.2	0.1	0.2
Paraguay	0.2	0.5	0.5
% LA imp./total imp.	7.4	5.5	5.2
% Brazil imp./total imp.	2.6	2.0	1.9

Source: Eurostat.

Table 7: Economic Community's Exports ($ billion)

	1985	1990	1991
World	287.8	533.1	520.9
EFTA	64.4	141.5	133.9
US/Canada	72.5	109.1	99.0
Japan	8.0	28.8	27.3
ACP (69)	14.9	21.1	19.6
Mediterranean countries	33.5	57.9	56.5
Latin America	11.1	19.2	21.5
Brazil	2.1	4.7	4.9
Mexico	2.1	5.0	5.9
Colombia	0.8	1.0	1.1
Venezuela	1.7	2.2	2.3
Chile	0.6	1.5	1.4
Argentina	1.2	1.5	2.1
Uruguay	0.2	0.3	0.4
Peru	0.4	0.4	0.5
Ecuador	0.4	0.4	0.6
Bolivia	0.2	0.1	0.1
Paraguay	0.2	0.3	0.2
% LA imp./total imp.	3.9	3.6	4.1
% Brazil imp./total imp.	0.7	0.9	0.9

Source: Eurostat.

PREFERENTIAL TRADE AGREEMENTS IN THE CARIBBEAN: ISSUES AND APPROACHES

Winston Dookeran[1]

Introduction

The structures that defined the Caribbean economic picture over the past 40 years were the "triangular trade" (export of primary products and import of finished goods) of the preindependence period, followed by multinational corporations bringing United States hegemony, and, most recently, structural adjustment programs supervised by the World Bank and the IMF. This analytical framework generated theories of exploitation, neocolonialism, and marginalization coupled with the persistent call (with heavy moral and political overtones) for protection, preferences, special consideration, aid, and trade and investment support.

One of the disturbing aspects of the Caribbean's economic history is that these short-term measures have discouraged the development of long-term strategic plans. Primary export commodities such as bananas, sugar, and rum, which have traditionally sustained many Caribbean economies, have survived well beyond their natural lifetimes through preferential treatment. New manufactures have also been protected by preferential treatment from the major trading partners. This has allowed Caribbean countries to enjoy a level of access to the international trading system that is not compatible with its levels of production, productivity, and international competitiveness.

Global trends are characterized by moves toward liberalization of trade through the reduction of tariff and nontariff barriers. Competition, efficiency, and productivity have become the new watchwords. The Caribbean's underdeveloped productivity severely constrains participation in increasingly liberalized trade regimes. While Caribbean countries have realized that preferential treatment has not engendered a competitive production base, preferential agreements can play an important role *in the short term* in the attainment of desired levels of production.

Global trends threaten the existence and nature of such agreements between the Caribbean countries and their traditional trading partners, the United States and Europe. These changes will significantly affect the trade sectors of the region's economy, which will require a strategic policy response in both the short and long terms, in order to allow the Caribbean countries to find a new niche in the world economy.

This paper discusses key policy issues that face Caribbean countries as they respond to rapid changes in international trade. These issues are presented with regard to the major preferential agreements that define Caribbean trade: the Caribbean Basin Initiative (CBI), the CARIBCAN, the Lomé Convention, and the CARICOM External Tariff (CET). The paper also assesses the impact of such arrangements, explores their future in light of current trends and issues, and suggests policy directions for Caribbean countries to deal with them.

[1] The author gratefully acknowledges the invaluable research of Hitomi Rankine.

Caribbean Preferential Trade Arrangements

The Caribbean Community (CARICOM) includes Barbados, Guyana, Jamaica, Trinidad and Tobago, Antigua and Barbuda, Belize, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. Its population of 5.5 million compares to that of Denmark, and its GNP is approximately $10 billion. The countries have very open economies with an average trade-to-GDP ratio of 60 percent.

The largest portion of Caribbean exports goes to the United States and Europe, and preferential access with these trading partners is established under the CBI and the Lomé Convention. A long-standing relationship with Canada is covered by the CARIBCAN trade agreement. Preferential access existed prior to these schemes under arrangements such as the Generalized System of Preferences (GSP).

The Caribbean Basin Initiative

The Caribbean Basin Initiative (CBI) was enacted by the Caribbean Basin Economic Recovery Act (CBERA) in January 1984. The CBI was seen as a change in United States foreign economic policy from multilateralism in trade relations to emphasis on domestic interests. The "magic of the market place" was to pull the Caribbean Basin countries out of the social and economic slump. It was the first time that the United States granted preferential economic treatment to an entire geographic region.

The CBI granted duty-free treatment to a range of goods from the Caribbean, subject to rules of origin, and it excluded specific items. The arrangements under the CBI were of indefinite duration, but they may be terminated at any time by the United States. The CBI's features include:

- **The 807 Program,** which provides that articles assembled in CBI countries using, in whole or in part, US components, are subject to reduced duty; and

- **The CBI Special Access Program,** which uses guaranteed access levels (GALs) that are applied (after negotiation) for specific items assembled in the Caribbean Basin from fabric manufactured and cut in the United States.

Supporting mechanisms for the achievement of the broader objectives of the program include:

- a tax exemption allowing tax deductions for companies holding meetings in CBI-approved countries;
- promotional programs by United States federal and state agencies and private-sector organizations to facilitate investment and increase production capacities;
- increased assistance for private-sector development; and
- access to investment funds under the 936 program.

Impacts of the CBI

From the beginning, the CBI was expected to have little, if any, positive effect on the economies or the social problems of the participating countries, despite the stated goals of the United States. The CBI's duty-free benefits were extended to only 7 percent of the region's exports.

Economic growth. The provisions of the CBI were unable to halt the decline of the GDP growth rate, which started in the pre-CBI period. During the period 1984-87, most countries experienced positive growth but only six achieved real GDP growth of 6 percent or more. The fact that the largest countries tended to have the lowest growth dampened average growth.

Trade. Caribbean exports to the United States are gaining momentum. U.S. trade figures with the Caribbean Basin for the first half of 1991 and 1992 show that U.S. imports from nine countries had significant proportional increases, and only three had significant decreases in total exports to the U.S. The CBI was characterized by poor performance in the early years. In 1987, imports were only 5 percent above the level of 1983, due in part to a series of crises in CARICOM: intraregional trade plunged because of debt, breakdown of the multilateral clearance facility, and temporary closure to CARICOM of one of the major markets, Trinidad and Tobago.

Diversification. There has been some diversification into manufacturing, tourism, and financial and transportation services, but all of the countries can still be described as producers of commodities. The diversification effort that began with the CBI holds potential for further increases.

Agribusiness. CBI had the greatest impact on agribusiness. Preferential treatment ranged from 25 percent to 75 percent, and agribusiness recorded the fastest and most stable growth from 1983 to 1986. Four countries achieved growth rates between 3 percent and 7 percent between 1984 and 1987.

Investment. Direct, long-term foreign investment dropped between 1984 and 1987, mainly as a result of the severe drop in Trinidad and Tobago. But during this same period the Dominican Republic, Costa Rica, and Honduras showed increases in foreign investment. Large amounts were also invested in the Bahamas and Panama.

The 936 program, which was linked with the CBI under the CBERA, has been responsible for increasing levels of investment in the Caribbean. A study by Caribbean/Latin American Action (C/LAA), a Washington, D.C.-based group that promotes business development, has concluded that Puerto Rico's low-interest funds provided to the region under the 936 program represented the single largest source of project loans to qualified Caribbean Basin borrower countries in 1991, an average of 22 percent of total loans disbursed in the region from 1988 to 1991. Its growth as a source of funding has also exceeded all other loan sources. Ten Caribbean countries signed the Tax Information Exchange Agreements with Washington and therefore currently qualify for loans through the 936 program. Trinidad and Tobago has received the most from CBI loans: $275 million. Jamaica and the Dominican Republic are close behind.

Financial and technical assistance. Some increase has been recorded. United States economic assistance to the CBI region in 1987 was 48 percent higher than in 1983, but the level declined in 1988. The CBI replaced the traditional mixed economics of the Caribbean with a new emphasis on the private sector. This emphasis is alleged to have aggravated social tensions and increase political instability, and is even charged with having increased migration from the Caribbean. It has also been said that the CBI limited the economic sovereignty of the Caribbean countries, and that the bilateral character of the agreements signed threatened regional integration and heightened economic differences.

The most important contribution of the CBI has been its role in helping the region to offset, if only minimally, the broader decline in trade. The trade benefits of the CBI have been concentrated in the Central American countries.[2] The impacts of the CBI have not yet met its stated goals in most of the 22 countries that have acceded to its terms. It has, however, begun a process of economic restructuring, with economic and social implications.

CARIBCAN

Jamaica's Prime Minister, Edward Seaga, presented a detailed proposal for aid to the Caribbean region at a 1985 meeting of CARICOM heads of government. Canada responded with the CARIBCAN, which was announced in February 1986 and took effect on June 15, 1986. Canada had previously extended preferential entry treatment to Commonwealth Caribbean goods through the Canadian General Preferential Tariff (GPT), the general preferential program for developing countries (GSP), and the British Preferential Tariff.

CARIBCAN's basic objectives differed from those of the CBI. CARIBCAN's objectives were to:

- enhance bilateral commercial relations between Canada and CARICOM states,
- enhance CARICOM trade and export-earning potential,
- improve trade and economic development,
- promote new investment, and
- encourage economic integration and cooperation.

CARIBCAN's main features are the unilateral extension of preferential, duty-free access to Canadian markets for most imports from the Caribbean, subject to rules of origin and shipping requirements, and measures to encourage Canadian investment and other forms of industrial cooperation with the region. Products excluded from preferential treatment under the program continue to be eligible for preferential treatment under the GPT and BPT, if such eligibility exists under those programs. CARIBCAN included a number of provisions that provided training, strengthening of marketing skills, promotional activity, and a number of business-related activities springing from the private sector.

Substantial improvement in the original concessions granted by CARIBCAN were made in 1990 in the areas of rum bottling and inclusion of leather luggage and certain vegetable-fiber products. These changes opened duty-free access to Canada to 98 percent of all CARICOM goods.

Complementary provisions for investment and facilitation of trade and industrial cooperation have concentrated on the creation of linkages between the private sectors of Canada and the Caribbean. Again, the private sector continues as a key provider of development initiative in the region.

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2. Clarke, D. P., "Measurement of trade concentration under the United States' Caribbean Basin Initiative." *World Development* Vol. 17 no. 6.

No time limit has been attached to CARIBCAN, but an extension of the waiver granted by the GATT in 1986 for 12 years must be sought in 1988. The waiver exempted Canada from the requirement contained under paragraph 1 of the General Agreement that the same duty-free treatment must be extended to like products of any Contracting Party. Under the provisions of CARIBCAN, Canada may suspend or withdraw duty-free treatment in whole or in part from any beneficiary country. The beneficiaries of the program are the English-speaking Caribbean countries that maintain links with the Commonwealth: CARICOM countries plus Anguilla, Bermuda, the British Virgin Islands, the Cayman Islands, and the Turks and Caicos Islands.

The Impact of CARICOM

From the beginning, expectations of the program were not high, primarily because the value of the dutiable products constituted a small share of Canada's imports compared with the range of imports already accorded zero tariff access by such programs as MFN, the BPT, and the GPT.

Henry S. Gill (1992), consultant to the Latin American Economic System (SELA), has observed that any evaluation of CARIBCAN's impact with respect to its goals is difficult because of "isolating the effects of this arrangement from others deriving essentially from the pre-CARIBCAN relationship." He notes that this is especially the case with industrial cooperation activities. However, he attempts to examine the relationship in three main areas: trade, industrial cooperation, and investment. His results, published in June 1992, are summarized below.

Trade. In general, CARIBCAN has had little positive impact on Caribbean exports to Canada, and the impact that has occurred was concentrated in a few of the larger countries. Caribbean countries have expressed concern about various aspects of the agreement's trade provisions related to the origin criteria, requirement for direct shipping, and product exclusions.

The CARICOM Secretariat's statistics show that:

- Canada's share of CARICOM exports has varied considerably, ranging between 3.7 percent and 6 percent during the period 1984 to 1990;
- CARICOM exports to Canada have risen in value since the start of the CARIBCAN program, from EC$455.3 million in 1986 to EC$498.3 million in 1990, an increase of only 9.4 percent, lower than changes in global exports, which rose 46.5 percent over the same period; and
- major exporters have been Jamaica (66 percent of total exports in 1990), Trinidad and Tobago, and Grenada. By contrast, the OECS countries experienced a slight increase in exports from 1986 to 1988, and decreases in 1989 and 1990.

Gill's examination of the figures reveals that imports valued at $11.2 million, 4.2 percent of total trade and 2.7 times the total CARIBCAN trade, did not qualify under the arrangement because of such factors as requirements of origin, and direct shipment, among others. An examination of the tariff treatment figures for 1987 shows that duty-free imports under CARIBCAN were valued at less than 1.6 percent of duty-free imports and 1.5 percent of all imports.

Industrial cooperation and investment. Some success has been reported, notably in the establishment of National Development Foundations and Institutes in nearly all CARICOM countries, and the funding of more than 376 business proposals from the region, most under the Industrial Cooperation Program in the form of entrepreneurial and management training, standards development, investment promotion, and institutional strengthening. Investment is said to have been hindered by distance and shipping costs. Canadian investment in the Caribbean area has been mainly in the financial sector, communications and other utilities, and tourism. CARIBCAN has become a focal point of activity and has strengthened commercial relations between Canada and the Caribbean countries over the years.

The Lomé Convention

Lomé I was negotiated in 1975 to legalize and facilitate cooperation between the European Community and the African, Caribbean, and Pacific (ACP) group of developing countries that had historic links with European states. Subsequent conventions were signed in 1979 and 1984. The latest, Lomé IV, was finalized in 1990 and remains in force until 2000. The ACP states currently number 69, 13 of which are Caribbean, the 12 members of CARICOM plus Suriname. Cooperation under the conventions is directed towards development centered on human rights as a basic requirement of real progress.

Lomé IV offers opportunities for ACP-EEC cooperation in aid and trade, and it makes available a total of ECU 12.8 billion, an increase of 40 percent in nominal terms, and 20 percent in real terms and adjusted for inflation, over levels provided in Lomé III. A notable change is the increased emphasis on the role of the private sector in stimulating growth and diversification of ACP countries, and the special inclusion of provisions for the development of tourism. Provisions of the latest convention represent a considerable improvement for the effectiveness of the convention. Trade provisions are also considerably improved in the areas of commodities, rules of origin, and access.

The main provisions of the Lomé IV Convention are:

- *Trade.* Provisions for trade include nonreciprocal duty- and quota-free access for most ACP exports, clarified and relaxed rules of origin with provision for exemption based on value added, safeguarding of the interest of its traditional suppliers of bananas after the completion of the internal market, guaranteed purchase of a stipulated quota of sugar and allocation of funds for promotion of trade and tourism. There is also protection for commodities that are of crucial importance for most ACP countries, and specifically for the Caribbean states, as a result of the downward trend of agricultural commodity prices (through STABEX and SYSMIN). Reduction of dependence on these commodities is sought through support for diversification efforts in processing, marketing, distribution, and transport.

- *Development cooperation.* The promotion and expedition of the economic, cultural, and social development of the ACP countries is the objective of the Aid for Development Financing program. Two major innovations have been support for structural adjustment (with the aim of adjustment with social equity) and provisions for relieving the crippling burden of debt owed by ACP states. Other areas for cooperation include support of the private sector, promotion of environmental issues, population growth, and agricultural,

cultural, social, and industrial cooperation. An important aspect of the convention is its support to regional cooperation, which is intended to aid the efforts of ACP states to promote development through regional cooperation and integration.

The Impact of the Lomé Convention

The European Community is a major market for the developing countries. In 1990, it absorbed one quarter of all developing country exports. It is especially important to the smaller island producers of traditional commodities such as sugar, bananas, and rum.

The regional cooperation program has led to establishment of the Caribbean Forum, which includes the CARICOM states, Haiti, and the Dominican Republic. This forum has agreed that the areas of regional cooperation it covers will be agriculture, transport, tourism environment, and human resources.

The CARICOM-Venezuela Agreement

On January 1, 1993, CARICOM and Venezuela agreed to a bilateral treaty intended to increase levels of trade. The treaty will allow one-way preferential access for CARICOM goods to Venezuela's market and the gradual reduction of tariffs over five years. Duty-free entry of agreed imports is anticipated at the end of that period.

CARICOM members will then start a phased reduction of tariffs for Venezuelan goods for another five-year period. At the end of ten years, totally free trade (except in mutually agreed goods) will be in place between CARICOM and Venezuela. CARICOM members will also grant Venezuela MFN status in the application of customs tariffs over the first phase. No new quantitative restrictions will be applied to imports from Venezuela. Venezuela has officially implemented the agreement, but not all the CARICOM member countries have ratified it.

CARICOM imports from Venezuela are currently about $360 million per year, and Venezuela currently imports goods worth about $90 million per year from CARICOM countries. In recent years, CARICOM exports to the Latin American market, and particularly to Venezuela, have increased. The agreement is expected to yield great results for the CARICOM countries and is a forerunner to what is hoped will be a series of trade agreements with Latin American countries and economic groups. Colombia may be the next country to link up with the Caribbean region in this way.

Intra-CARICOM Arrangements: The Common External Tariff

The Common External Tariff (CET) replaced quantitative restrictions as the principal instrument of protection in the CARICOM on January 1, 1991. The Common Protective Policy, which engendered the CET, was intended to serve as an integrative force for the economies of CARICOM members by creating an enlarged and more secure market. The objectives of the CET, as agreed in 1986, are:

- protection for regional agricultural and industrial production of finished goods, raw and intermediate materials, and capital goods; and
- support for development of internationally competitive products in the Common Market.

The revised CET was approved at the Special Meeting of the Conference of Heads of Government of the Caribbean Community in October 1992. It established a rate structure in the CET of 5 percent (0-5 LDCs) to 20 percent by January 1998 through "phased reduction of the current rate structure of the CET."

The phased reduction is planned to be carried out as illustrated in Table 1. The proposal for the revised CET was presented to the special meeting of the Common Market Council in October 1992, a year earlier than the scheduled comprehensive review of the 1991 CET. It was formulated as a direct response to the trends of trade reform and liberalization in the international economy, and the perceived need to encourage Caribbean economies to compete in the new environment.

The move to lower barriers to intra-Caribbean trade took place following the realization that the existence of preferential agreements was threatened and their benefits stood to be eroded by the successful completion of negotiations within the Uruguay Round of GATT trade negotiations.

Table 1
Implementation Schedule of the CET

Period of application	Implementation period	Rate structure
Jan 1, 1993-Dec 31, 1994	Jan 1, 1993-Jul 1, 1993	5 (0-5 LDCs) to 30/35
Jan 1, 1995-Dec 31, 1996	Jan 1, 1995-Jul 1, 1995	5 (0-5 LDCs) to 25/30
Jan 1, 1997-Dec 31, 1997	Jan 1, 1997-Jul 1, 1997	5 (0-5 LDCs) to 20/25
Jan 1, 1998 onward	Jan 1, 1998-Jul 1, 1998	5 (0-5 LDCs) to 20

The rates of the new CET were based on eight principles, the two most important of which were the achievement of international competitiveness and efficient production for both the regional and international markets. A comparison of pre-existing rate treatment with the new CET is shown in Table 2. The eight principles were:

- *International competitiveness:* The tariff structure should support the development of internationally competitive production in the Common Market.
- *Efficient production:* Overprotective rates should be avoided and rates that keep production costs low should be implemented. Unrestricted intraregional competition should be encouraged, and subsidies should applied in extraregional markets should be taken into account.
- *Cost of living:* No undue increase in the cost of living should result.
- *Government revenue:* Needs of member states should be taken into account.
- *Removal of exemptions:* Uniform treatment of inputs across CARICOM would require removal or reduction of the exemptions regime.
- *Commodity-based tariff:* Simplification of the structure by applying one rate to a good regardless of economic use.
- *Special measures for the less-developed countries:* Special needs of LDCs should be taken into account.
- *Simplification and transparency:* Simplification of the structure, minimization of the number of rate bands, and reduction of the need for discretionary application in the routine administration of the tariff should be a basic consideration.

Consideration of the factors above led to the classification of goods schematically described in Figure 1. With reference to that figure, note:

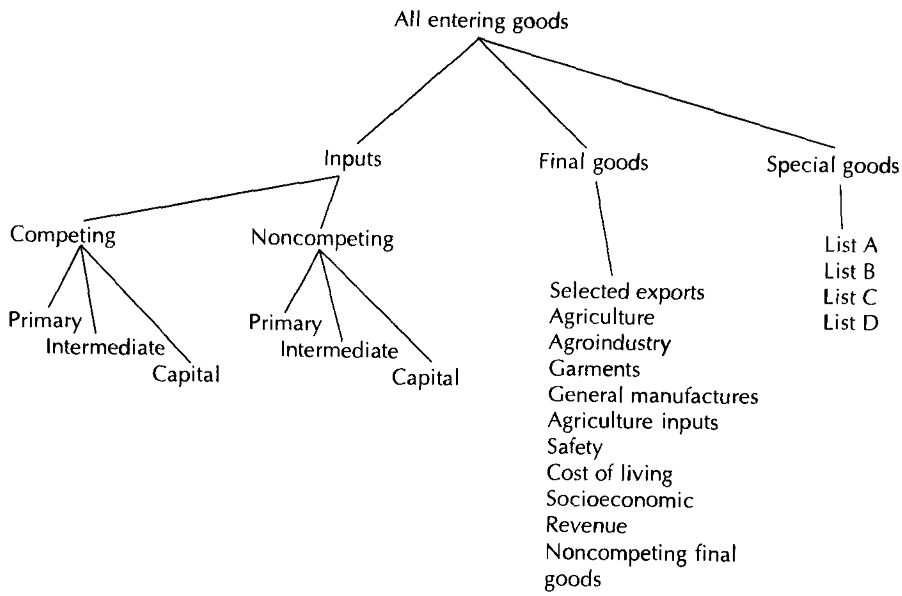
1. The term competing was taken to refer to those goods where "regional production, or immediate production potential from existing capacity, amounted to over 75 percent of regional demand/consumption."[3]

2. The categories of final goods may be identified as:

   - *Selected exports:* goods traded intraregionally and extraregionally insignificant quantities.
   - *Agriculture:* vegetable oils and primary agricultural products traded in either fresh, frozen, or chilled form.

3. Report of the Working Group of Experts on the Common External Tariff.

Figure 1: The Structure of the CET
(Classification of goods)



- *General manufactures:* goods produced in CARICOM at a level which would satisfy 75 percent of regional demand, and are not specifically identified in the other final goods categories.

- *Agriculture inputs:* goods considered agriculture inputs include insecticides and herbicides, planting materials, and fertilizers that have been accorded duty-free treatment.

- *Safety:* goods used for the protection of life and limb.

- *Cost of living:* goods considered to have an impact on the cost of living.

- *Socioeconomic:* goods that are considered to be important for, *inter alia*, educational, cultural, training, medical, and sporting purposes.

3. Special goods belong to one of four categories:

- *List A* consists of goods of which member states wish to encourage production but would not otherwise qualify for competing rates.

Table 2
Comparison of Rate Treatments under the CET

Categories	--- Previous rates --- MDCs	LDCs	Rates from Jan 1993 to Jan 1998
Noncompeting primary inputs	0-10	0-5	5 (0-5 LDCs)
Noncompeting intermediate inputs	0-10	0-5	5 (0-5 LDCs)
Noncompeting capital inputs	0-10	0	5 (0-5 LDCs)
Competing primary inputs	30	30	20 to 10
Competing intermediate inputs	30	30	25 to 15
Competing capital goods	20	20	25 to 15
Selected exports	20-30	20-30	20 to 10
Agriculture	45	45	40
Agriculture inputs	0	0	
Cost of living, socioeconomic and sociocultural	0-30	0-30	0-20 until Dec 31, 1996[a]
Safety	0	0	0 to unspecified
Agroindustry	45	20-45	30-35 to 20
Garments	45	20-45	30-35 to 20
General manufactures	45	20-45	30-35 to 20
Revenue and noncompeting final goods	30	30	25 to 25-30 to 20-25 to 20
List A	susp. rates	susp. rates	susp. rates until Dec 31, 1996
List B		susp. rates	susp. rates (LDCs) until Dec 31, 1996[b]
List C	min. rates	min. rates	min. rates
List D (parts 1 and 2)		susp. rates	susp. rates (LDCs) until Dec 31, 1996[b]

a. Items to be included in other categories with the reduction in the levels of rates in the latter.
b. It is anticipated that on January 1, 1998, there will be no items in these categories.

- *List B* includes items for which implementation of the CET is to be delayed due to the considerable gap between prevailing rates and the proposed tariffs.

- *List C* refers to those items that are traditionally significant revenue earners, and also items on which agreement on tariff levels has not been achieved.

- *List D* consists of those items for which the CET is to be suspended. These include items of specific interest to Belize (part 1), rice in the cases of Antigua and Barbuda, Dominica and Jamaica (part 2), and pharmaceuticals in the case of LDCs (part 3).

4. Integral to the structure is the list of Conditional Duty Exemptions, which includes goods that member states may exempt from duty under the CET. Where inputs were categorized as competing and were easily available, it was proposed that these be included in the List of Goods Ineligible for Exemptions.

5. The suspension of rates may be done only by the Council. In the intercessional periods of the Council, the Secretary General has been given the power to suspend the tariff.

6. The LDCs have been grated the facility to apply a rate between zero and 5 percent on noncompeting intermediate inputs and capital goods.

7. Agriculture has been accorded special status.

Extraregional Caribbean trade is vastly greater than intraregional trade. The conclusion that some have made is that the concern of fostering intra-CARICOM trade is overemphasized. However, it is instructive to note that intra-CARICOM trade constitutes almost 10 percent of all CARICOM trade (and it is growing) and in certain cases employs a substantial portion of a country's population.

Trends in International Trade

Multilateralism versus Regionalism. The trend towards multilateralism or globalization of trade is embodied by the conclusion of the Uruguay Round and seems to act against the "regionalizing" of trade embodied by the creation of the European Single Market, the North American Free Trade Agreement (NAFTA), and free trade agreements in Latin America and the Pacific Rim. The impact of two seemingly opposed trends is unclear. According to Trevor Harker, ECLAC Regional Economic Advisor to the Caribbean:

> There is some debate about the rationale and final outcome of regional blocs. Will they be building blocks to multilateralism, or stumbling blocks? Will the blocs reduce high tariffs between countries at the regional level, and lead later to tariff reductions or tariff elimination between the blocs, thus later leading to true multilateral trade?

Trade liberalization is a feature of both trends, and has been recognized as an inevitable route, whether in blocs or globally. It implies the minimizing of nonreciprocal provisions in trade agreements on which Caribbean countries have relied to date. Trade liberalization acts against preferential terms and protectionism. On the one hand, there is the need to protect industry in the short term, and on the other hand there is the need to challenge it to achieve excellence in the long term. The strength of protectionist influences has led one observer to conclude that there is no such thing as free (liberalized) trade, only *freer* trade.[4]

The consideration of trends and characteristics of international trade lead to an examination of the ways these trends may affect the Caribbean's position in existing trading relationships and decisions to be made by Caribbean countries in dealing with these effects. The conflicting nature of several of the trends and the decreasing popularity of the former *modus operandi* of the Caribbean will force the region to decisions about policies for approaching new regimes, and these policies will determine approaches to existing preferential arrangements.

Domestic Policies and International Trends

The foreign trade policy directions taken by CARICOM countries will be influenced by, and will influence, the nature of internal arrangements and policies.

The Regional Integration Movement

Discussion of Caribbean regional integration has concentrated on economic rather than political issues since the dissolution of the West Indian Federation in 1962. The underlying urge for a West Indian identity and the search for more economic space have kept alive the ideals of regional integration, an ideal that has become even more timely and relevant in today's new trading arrangements. Practical aspects relating to the possibility of region-wide marketing, increased economies of scale, and development of the services sector have also been part of the long-range vision.

The West Indian Commission has stated that concepts of CARICOM focus on a "community of sovereign states who by treaty agree to the pooling of certain of their sovereignties and to exercising them collectively in very specific respects." The Commission emphasizes that "it is the sharing of the exercise of sovereignty, not a transfer of it, that is involved in the integration process."[5]

Prime Minister Erskine Sandiford of Barbados said at the opening of the eleventh Summit of CARICOM Heads in 1990:

> For me the Caribbean Community is nothing more and nothing less than the efforts of the Caribbean people to create a new and unique political entity that respects the national sovereignty of each individual territory, while at the same time pooling aspects of that sovereignty and pooling aspects of their resources in order to promote and preserve peace, promote and preserve democracy, promote and preserve fundamental human rights and the rule of law, and promote and preserve economic and social development among Caribbean people.

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4. Hosten-Craig (1992).

5. Report of the West Indian Commission.

The Report of the West Indian Commission further states:

> Sovereignty is one thing; contractual obligation is another. We cannot agree to act together in particular ways and remain free to act as we please, or as every passing advantage induces us. If integration is to work to the long-term advantage of the region and all its member states, CARICOM commitments must be binding commitments, morally, functionally, legally.

International developments in trade regimes may hold particular dangers for the regional integration movement. Approaches to new "liberalized" regimes on a CARICOM-wide basis will present dangers for the more vulnerable LDCs of the region and greater benefits for the MDCs. Careful examination of the modalities of such an approach will be required. Individual approaches, while not holding much scope for success (except in the cases of the most developed Caribbean countries) in terms of the lack of negotiating weight and power, may well hinder moves to the ideally integrated Caribbean. Policy instruments for liberalized economies (for example, "floating" currencies) may also conflict with policy instruments such as a common currency.

At the same time, it is evident that approaches to the European Community via the Lomé Convention will require increasing cohesion in the face of pressure from countries that are not part of the ACP group and increased attention to Eastern Europe and European recession. Commitment to the integration process would serve the Caribbean's interests best.

Regional analysts have generally agreed that the Caribbean countries remain vulnerable to the changing international economic order, not only because they have relatively weak economies but also because they remain politically divided.

The Common External Tariff

It has been recognized that protecting Caribbean industry from extraregional competition is inconsistent with trends toward trade liberalization, and the special meeting of the Conference of Heads of Government of the Caribbean Community in October 1992 decided to reduce the CET stepwise until a range of 5 percent to 20 percent is achieved by 1998. This time frame may allow Caribbean countries to participate fully in the NAFTA, given compliance with other requirements and the likelihood that the Caribbean countries will not be considered for accession at least on a reciprocal basis for a few years.

The CET in its present form does not conflict with the GATT. Barbados, Jamaica, and Trinidad and Tobago are contracting parties to the GATT and have received requests from Canada and the United States for the reduction of tariff and nontariff barriers and for the binding of tariffs on a number of products. With the finalization of the revised CET, it has been decided that counteroffers (on the basis of the CET) to those requests will be made, and requests made to Canada and the U.S. to eliminate and bind tariffs on the items currently subject to duties or other charges under CARIBCAN and CBI.

The revised CET does not conflict with arrangements under the Lomé Convention. The time frame for reduction of the CET allows for new Lomé negotiations (if the option is then still open) on a more reciprocal footing.

A number of policy dilemmas arise when considering the role to be played by the CET. There is a danger that while provisions are made for the encouragement of intra-CARICOM trade, a bias may be developed against exporting outside CARICOM, against the long-range objective of global competitiveness.

The Maxwell Stamp PLC study on trade policy reform in Trinidad and Tobago raises related issues. It states:

> ...it is necessary to consider whether CARICOM membership or current CARICOM arrangements are a constraint to the removal of antiexport bias and therefore constraint to the promotion of extra-CARICOM exports. If the common external tariffs (CET) of CARICOM were the only source of antiexport bias, then CARICOM arrangements would necessitate immediate attention. But there are parallel trade policies in operation currently in Trinidad and Tobago, that induce a greater antiexport bias when incentives to export outside CARICOM are compared with the incentives to sell to the local market rather than with those to sell in CARICOM. There is likely to be considerable scope for lowering antiexport bias by trade policy reform outside of the CARICOM framework.

Other regional goals such as the free convertibility of currency will require closer examination to determine the implications of moves towards trade liberalization.

Recommendations of the West Indian Commission

The report of the West Indian Commission indicates a general regional consensus on the importance of promoting export-led growth. Policy issues and prescriptions are:

Regional directions for promoting export-led growth:
- Establishing mobility of capital within CARICOM
- Ensuring that respective currencies are freely convertible with each other
- Establishment of regional trading houses
- Mobility of labor
- Reducing antiexport bias
- Expanding CARICOM trade

Extraregional trade:
- Ensuring that the emergence of the NAFTA does not destroy the benefits of the CBI and CARIBCAN
- Negotiation with the United States, Canada, and Mexico and convincing NAFTA negotiators that the CBI and CARIBCAN must be maintained
- Securing parity with Mexico regarding access within NAFTA and a continuation of the nonreciprocal arrangements established under the CBI and CARIBCAN
- Sustaining movement toward diversification of trade with a focus on agribusiness, manufacturing, and service sectors.

Policy Approaches to Preferential Arrangements

Caribbean countries must keep in mind the need to widen and deepen the Caribbean community, decide on their levels of commitment to the process, and determine the effect of their policy choices in the international scene on their regional goals. International developments also hold implications for the preferential agreements under which Caribbean countries have operated for the larger part of the critical developmental stage. These agreements, while showing varying levels of performance to date, hold potentially important roles as facilitator of trade development. Identification of the issues and exploration of policy choices remain imperatives.

NAFTA

The effects of the NAFTA on Caribbean economies have been widely debated without producing a solid consensus beyond the identification of the textile and apparel sectors as particularly vulnerable. The textile industry has become one of Jamaica's newer engines of growth under a bilateral pact with the U.S. which was extended in January 1993. It is also widely held that the Caribbean will suffer from a depletion of investment. Talks have also been taking place about the future of Caribbean sugar exports to the U.S.

NAFTA's North American coverage will hold similar implications for trade with Canada. The NAFTA has not only drawn attention away from the interests of the Caribbean, but also threatens to introduce Mexico as a competitor for Caribbean goods and services in the Canadian market. This scenario applies particularly to products excluded from preferential access under CARIBCAN. These products represent a small fraction of total exports to Canada from the Caribbean, and the negative effect on Caribbean economies may not be great in the short term. Limiting the market for these goods may, however, stunt future growth of its market share.

Susan Howell, Canada's Trade Commissioner to Trinidad and Tobago, has attempted to put things into perspective with regard to the extent to which CARICOM countries will be affected by competition from Mexico under NAFTA. In an address to the University of the West Indies Seminar on *Strategies for Survival: CARICOM Manufacturing and Export in a World of Change,* October 23, 1992, in Port of Spain, she stated:

> And let's put things in perspective. Eighty percent of Mexico's exports to Canada already come in duty-free, compared with 98 percent of CARICOM's. So CARICOM has in fact been competing with Mexico, on close to equal terms, for years. And competing successfully. In fact most Mexicans would probably say that CARICOM has had the advantage, with its English-speaking labor force, on average better educated than Mexico's, its generally better infrastructure, its familiarity with the North American markets and business practices, and significant Canadian and U.S. investment presence already. This is a lead over Mexico which CARICOM still maintains and which won't go away quickly.

Impacts of NAFTA on the CBI and Policy Directions

The current advantages of the CBI are likely to be dramatically eroded by Mexico (and in the future by the Latin American countries) within the NAFTA. The lack of competitiveness in terms of marketing, physical infrastructure, and labor costs that hindered Caribbean countries from taking full advantage of the preferential regime will accelerate that erosion unless seriously dealt with. The agricultural sector stands to lose its current positive growth in exports to the United States in the face of Latin American competition. The close geographical proximity of Mexico to the American marketplace makes it competitive in terms of transportation costs. Mexico also threatens to draw large volumes of investment away from the CARICOM region: an estimated $24 billion in overseas investment has been received by Mexico during the three years of negotiating NAFTA.

Caribbean countries have little choice but to open their markets, at least in the long term. This means participation in the NAFTA sometime in the future. The timing and nature of this participation must be determined while keeping in mind the implications of this participation for the CBI.

Docking. The agreement, as it stands, includes an accession clause that will allow other countries to join the accord "if the NAFTA countries agree, and subject to the terms and conditions that they require and to the completion of domestic approval procedures in each country."

Caribbean countries have the option of docking into the NAFTA one by one as they gradually meet requirements for access. However, this implies a delay, and any delay will be costly with the anticipated divergence of interest from the area. This type of approach will not compromise the benefits of the CBI for the other Caribbean countries, since agreements under the CBI are made country by country. It is envisaged that there will be limited scope for tailor-made agreements for individual countries.

Forging a new relationship (or modifying an old one). The approach that is perceived to hold greater potential benefit for the CARICOM unit is the forging of a new relationship along the lines of a nonreciprocal (initially, but with increasing reciprocity) arrangement with the entire NAFTA group. This will require modification of the CBI's provisions to maintain coherence between the new relationship and the relationship with the United States. While current CARICOM efforts seem to be concentrating on the U.S. market, it must be noted that the traditional ties with Canada, and Mexico's more recent interest in the Caribbean hold potential for the development of an arrangement compatible with the needs and goals of the Caribbean region. Mexico as a market has not yet been exploited fully by Caribbean businesses and industry, and the demand created by the anticipated growth of that country's economy should not be overlooked.

Other directions seem to have been identified. Richard L. Bernal, ambassador of Jamaica to the United States, identified some major proposals to the Ways and Means Committee of the U.S. Congress in September 1992. They were:

- **Preserve the viability of the CBI.** NAFTA should not erode the provisions of the CBI. This may require specific clauses to guarantee the nonerosion of CBI

- **Parity as a transitional arrangement.** The CBI modified to offer the same conditions of market access to the United States as those provided to Mexico under the NAFTA, to cover products exempted from duty-free treatment under CBI and those placed at a disadvantage by Mexican competition.

- **Phased reciprocity over a suitable adjustment period.**

- **Funding transformation.** Provision of resources to install new productive capacity and improve productivity and competitiveness.

- **Transparent process of expansion.** Procedures should be made known and criteria for eligibility for accession and specific docking provisions clearly defined.

A commentary by Peter B. Johnson in *US/Latin Trade* (February 1993) states:

> One condition is quite clear. The smaller countries will have to understand that the benefits of nonreciprocal trade, offered under the terms of the CBI of 1984, will not keep them ahead of competition for investment or for joint production arrangements. With tariff barriers under NAFTA gradually falling to zero, CBI countries could end up at a disadvantage in many product categories even if they joined the pact. This perhaps is not clearly understood by Caribbean leaders, although it is well known to U.S. firms sourcing products from these countries, and by the trade and commercial interests in the Southern U.S. states.

Impact of NAFTA on CARIBCAN

A Canadian study evaluating the impact of the Canada-U.S. Free Trade Agreement on Caribbean economies has concluded that the agreement would enhance levels of both trade and investment in the Caribbean, and that any displacement of these caused by the agreement would be outweighed by its expansionary economic effects for the region.

A similar study has been conducted on the impact of NAFTA on the Commonwealth Caribbean, with the same conclusion. It has also observed, however, that sales of some Caribbean products to Canada, notably in the areas of garments, fresh produce, and low-cost assembly could be negatively affected in the long run.

The West Indian Commission has recommended that CARICOM ensure that the emergence of the North American Free Trade Agreement does not destroy the potential benefits of the CARIBCAN, and that parity of treatment be extended to CARICOM by the U.S. and Canada when NAFTA is implemented.

More concrete Caribbean direction can be detected in the communique from the Fourth Intersessional Meeting of the Conference of Heads of Government of the Caribbean Community in March of 1993. This communique called upon the signatory countries to the NAFTA to "extend to CARICOM products not included in the Caribbean Basin Initiative (CBI) and CARIBCAN the same treatment accorded to these products originating from Mexico." The Special Meeting of the Heads of Government, held in October 1992, agreed to pursue the possibility of negotiating, as a group, a common position for entry into NAFTA under arrangements whereby the benefits under the CBI are maintained. A nonreciprocal arrangement is stressed here:

> Indications from the U.S. are that arrangements such as the CBI are unlikely to be maintained in their present form as the NAFTA proceeds. It was reported in December 1992 that the U.S. Congress will push for inclusion of the CBI countries in the NAFTA

on at least a limited basis, even if that participation is not initially reciprocal. Rep. Frank Guarini, D-NJ, stated, "Legislation is being drawn up now . . . (with) the goal and objective of extending the same considerations in trade to the Caribbean Basin Initiative countries that are being discussed now with Canada and Mexico." *The Caribbean Free Trade Agreement Act of 1993* is being proposed by certain sectors of the American Congress, and is aimed at the protection of Caribbean Basin countries from the effects of NAFTA.

Impact of NAFTA on Lomé IV

Accession to NAFTA may require that the Caribbean extend the same access to regional markets to the Lomé countries as to the NAFTA countries. Under Article 25 of the Lomé IV Convention, should CARICOM states become members of NAFTA (which excludes developed countries like Canada and the United States), they will be obligated to extend similar conditions to the EEC member states.

The Executive Director of the Caribbean Council for Europe, a private-sector Caribbean group that monitors developments in Europe that affect private-sector interests in the Caribbean, states:

> . . . probably the most difficult issue that the Caribbean is likely to face in its relationship with Europe, is the question of reciprocity. If the Caribbean wishes to achieve some form of docking arrangements with the NAFTA, it will be required to develop an approach that leads to two-way trade liberalization. Lomé, on the other hand, provides for free trade in only one direction, and sooner or later the Caribbean may come under pressure to forego its nonreciprocal Lomé arrangement if it wishes to accede to the NAFTA. The dilemma will be one of being forced to choose between friends.

Neville Nichols, President of the Caribbean Development Bank, states that the requirement of extension need not be detrimental, particularly if adequate safeguards and appropriate transition periods are negotiated.

The disparity in the developmental stages of the Caribbean countries, coupled with varying levels of demonstrated commitment to trade liberalization, cloud the clear determination of modalities for accession to the NAFTA by the Caribbean countries as a regional grouping. Already there is an apparent deference to Jamaica in the lead position in NAFTA negotiations, and one observer noted:

> Interestingly, the conflicting signals coming out of the recent meeting of the Heads seemed to suggest a two-tier approach. Jamaica might be allowed to pursue the NAFTA option on behalf of the rest of CARICOM, who might retain their freedom to decide on the outcome. At the same time, initiatives between Barbados, Guyana and Trinidad, and those within the OECS will be pursued in parallel to provide an option if the task of complete liberalization becomes too onerous to bear.

The only CARICOM country identified as being rated "B" in qualifying for accession is Jamaica, which has shown a remarkable commitment to liberalization. Trinidad and Tobago also recently began efforts to liberalize trade. To minimize the loss of trade and investment to Mexico, accession to the NAFTA as a group in some form or fashion will have to occur in the very near future. Such a relationship will necessarily include increasing levels of reciprocity, and this will again leave the less-developed Caribbean countries at a disadvantage.

The Single European Market

The Single European Market came into effect on January 1, 1993. It created a market with the freedoms of capital, labor, services, and goods. On March 8, 1993, the EC foreign and trade ministers signed an agreement that created a giant, 18-nation free-trade zone. This is expected to become law in 1993 and would extend the EC's single-market freedoms to the EFTA countries (Switzerland, Austria, Finland, Liechtenstein, Norway, and Sweden).

The traditional Caribbean commodities, sugar and bananas, benefitted from the pre-existing collection of individual countries that constituted the European market. Each European country was free to give special treatment to those Caribbean countries with which it had traditional ties. Under a single market, however, products imported by one country can circulate freely in other countries of that single market. Caribbean products therefore face increased competition.

There are a number of uncertainties. It is possible that for producers of raw materials, the single market will cause little change and may increase demand. But those countries that depend on manufactures may face being drowned out by internal competition. Proponents say that the growth generated by the economic stimulation provided by integration will enhance the growth of developing economies. However, it is envisaged that the impact of this effect will be much less than that experienced in the 1970s and 1980s.

It is already apparent that fears of the magnified attractive force of Europe as a production center may be justified, as large amounts of funds have been injected into Europe in anticipation of the increased market space and the increased opportunities for profits and sales. The opening up of Eastern Europe provides an abundance of cheap, skilled, and relatively well-educated labor. Eastern bloc countries may attract European capital away from the Caribbean.

It has been pointed out, however, that the ACP's lost ground on the EC market over the last few years has not been due to the "threat" of the single market but is due to the lack of adaptability and export orientation.

One development that requires the Caribbean's attention is the full accession of Spain, Portugal, and Greece to the EEC and the doubling of structural funds to these countries for the production of out-of-season tropical fruits. This will diminish the Caribbean's market shares of these products.

Impacts of the Lomé Convention

Move to Trade Liberalization

While the preferential treatment under Lomé IV is unlikely to be continued beyond the life of the present agreement, Caribbean countries face the challenge of engineering new bases of trade relations with free trade as a major objective.

It has been said that the increased allocation of aid and trade for the ACP grouping by the EEC under the latest convention is an indication of importance which the Community places on the strengthened relationships developed with the ACP countries, especially in light of the emergence of new domestic and international priorities.

The Community has provided some assurance to ACP countries that their needs will be kept in mind, with the agreement that no ACP state will be placed in a less favorable position than in the past after the formation of the single market. Annex XXIX from the Joint Declaration on Trade Liberalization reads:

> The contracting parties note that the Community is conscious of the need to ensure, in the overall application of the Convention, the maintenance of the competitive position of the ACP states where their advantages on the Community market are affected by measures relating to general trade liberalization.
>
> The Community declares its willingness, whenever ACP states bring to its attention any specific case, jointly to study specific appropriate action with a view to safeguarding the interest of the latter.

It has been emphasized that the developing countries with flexible production capacity will be able to take advantage of the enlarged market offered by the Single European Market, and the new opportunities for increased earnings. Mr. E. Perez Porras, head of the EC delegation to Trinidad and Tobago, further states:[6]

> Increased demand in the community for raw materials chiefly benefits these developing countries that can offer competitive and flexible supplies. The increased demand for consumer goods will be of greatest advantage to those countries where the process of industrialization is well advanced. The same will occur in the opening up of markets for services that will primarily benefit the developing countries that are already in a position to meet Community demand.

Market penetration of the single market will require finely tuned market investigation. Although trade barriers will come down, the preferences of individual countries will largely remain the same.

The Banana Issue

The issue of access of Caribbean bananas to European markets, where a uniform Community-wide arrangement would place Caribbean banana producers at a serious disadvantage vis a vis the Central American or "dollar zone" producers has proven to be a source of conflict between European private-sector interests and the European Council. A European Council of Ministers' decision to apportion a 2-million metric ton quota of Latin American bananas, which will be subject to a high duty, was met with hostility from Belgian, Dutch, and German fruit importers and has been fiercely criticized in GATT circles by representatives of Latin American producers. The quota is estimated to limit Germany's

6. Perez Porras, address to seminar on Strategies for Survival: "CARICOM Manufacturing and Exports in a World of Change." University of the West Indies Institute of Business, October 1992.

imports to only 50 percent of its current Latin American banana imports, while countries that have favored their former colonies' bananas will receive quotas several times their current levels. The fruit importers fear market distortions, reimportation from other EC members, price increases, and subsequent job losses. They also claim this would result in fewer sales of ex-colonial bananas, and nonachievement of the aim of protecting the ACP country banana producers, and have threatened to take the EC to the European Court of Justice over the ratification of the plan, which is due to take effect on July 1, 1993. The approval of the plan despite internal pressure may be an indication of the EC's commitment to the protection of the ACP interests in the era of the single market. A GATT arbitration panel has ruled the EC's restrictions on Latin American banana imports unfair and in violation of world trade rules.

Increased competition from trading partners within the single market also exists, and while quotas will continue, CARICOM could find itself producing at a loss. There is also research under way by Belgian scientists to produce a banana that is sweeter and smaller than Caribbean bananas.

The Future of the Lomé Convention

While Lomé IV offers nearly open access to Caribbean goods, at least for agricultural produce and manufactured goods, until 2000 and near automatic derogations for many manufactured and other products that do not meet value-added criteria, its existence in its present form beyond 2000 is extremely doubtful.

The ACP grouping has little to hope for in the way of additional funding in the second half of Lomé IV. Given current trends, it is also likely that new conditions will be introduced by the EC, conditions that relate to issues such as good governance, privatization, trade liberalization, the encouragement of the private sector, and the strengthening of regional integration. Caribbean arguments for special treatment stand to lose credibility in the face of the threat of war in the Balkans, starvation in Africa, and other more urgent situations.

There is need to develop long-term approaches to Europe as part of a "broader long-term regional approach to external trade relations" that recognize the value of the relationship. This has been emphasized by the Executive Director of the Caribbean Council for Europe, David Jessop. These approaches, he said, must include:

- Relocation of enhanced Caribbean diplomatic representation from London to Brussels, and strengthening of links and dialog with European countries with which there is no traditional relationship.

- Establishment by the private sector of a Caribbean trading house based in continental Europe and able to source and market products from the region.

- Recognition of the European presence in the Caribbean in the forms of Curaçao and the French departments, which offer access to Europe through a doorway recognized in the Poseidon arrangement of the Maastrict Treaty.

Latin American Free Trade

Latin America's regional trade boom is a result of the formulation of several major trading blocs that include:

- The MERCOSUR Treaty (Brazil, Uruguay, Argentina, and Paraguay)
- Chile-Argentina
- Colombia-Venezuela
- The Andean Pact (Colombia, Peru, Bolivia, Ecuador, and Venezuela)

The reduction or abolition of tariffs in these groupings have generated rapid expansion in trade. The largest bloc, Venezuela, Colombia, Mexico (the G-3) and five Central American nations reduced tariff barriers in the agreement on February 12, 1993. Trade between MERCOSUR countries increased 50 percent in one year. It is predicted that the formation of free trade pacts in South and Central America will accelerate.

The Caribbean is in a strategic position to be part of this movement. Several trade-related agreements have been made with Latin American countries in the past, the most recent being trade agreements between Venezuela and CARICOM. CARICOM goods stand to face competition from larger countries producing similar goods in the Latin American market. The trade boom is also likely to cause a sizeable increase in investment in the expanded Latin American market, in competition with the Caribbean.

The Caribbean seems to have decided that strengthened trade with Latin America is a priority. Widening of Caribbean integration can produce significant benefits. It is said that the CARICOM market of 5.5 million persons is but a microcosm of a market of 112 million that stretches from Central America to Suriname. Such a megabloc can wield enhanced bargaining power in international negotiations. In addition, it may attract greater trade and investment opportunities. Consideration must be given, however, to the danger of CARICOM countries being swallowed up in a Latin American megabloc.

Careful examination of the implications is required, and also of the Caribbean's position within NAFTA and its ability to withstand such competition. This examination must take stock of the time frames and market sizes involved.

Cuba's Strengthened Caribbean Relations

It is claimed that he emergence of a market-oriented Cuba will, in the words of David Jessop, "lead to the assertion of an hispanic identity for the Caribbean. The center of political and economic gravity of the region will shift causing *[sic.]* the Dominican Republic, Puerto Rico and the English-speaking Caribbean to have to reassess their regional and international economic strategies." Jessop also speculates that the change will cause significant cross-border trade and strategic investment in Cuba, and suggests other possibilities:

- Development of a new regional integration process that brings together the larger economies of the Western Caribbean (Jamaica, Puerto Rico, the Dominican Republic, and eventually Haiti).

- Erosion of preferential advantage as Cuba becomes a magnet for investment and tourism.
- Need for reassessment of the region's transport infrastructure, as an open Cuban market will first dislocate then divert regional and international services to new Cuban hubs.

Mr. Jessop goes on to suggest that the region must identify where its self interest lies and develop a strategy that positions neighboring economies so that they can take advantage of new economic links as they become available.

Other Issues

Other issues to be dealt with arise as a consequence of developments that are not necessarily trade related but hold important implications for the region's trading arrangements.

Domestic Arrangements

The United States has made it clear that those wishing to accede to the NAFTA will need to qualify to do so. Qualification will entail a substantial move to economic liberalization. Trevor Harker suggests that qualification might rest on four issues: democratization; macroeconomic stability; market-oriented policies, good standing with the GATT and willingness to phase out tariffs; and strong intellectual property and environmental protection. Domestic arrangements in most Caribbean countries will therefore have to be substantially reorganized.

936 Funds

Economic difficulties in the U.S. threaten to erode the benefits of the CBI. One of the CBI's more successful components, the 936 low-interest loan facility offered through Puerto Rico, was recently threatened by the proposals to cut section 936 entirely, but recent reports suggest that the U.S. Treasury is leaning towards limiting, rather than cutting, the program. The Clinton administration perceives the program as a way of providing aid to the region, but it likely to be reduced from its current $3 billion and new conditions may be added.

Proposals for change to the program include a "twin-bed" policy that would tie 936 loans for tourism projects offshore to hotel building in Puerto Rico. Caribbean government officials have reacted to moves to diminish the availability of the loan facility to the CBI. A meeting was held in February 1993 with Puerto Rican 936 companies and officials from C/LAA to discuss strategy for the defense of the program. A call has been made for Caribbean countries to lobby for support to the continued existence of the program, a vital source of financing for the region. Caribbean beneficiaries of the 936 program have been charged with being surprisingly silent to developments in the 936 debate.

A concerted effort is needed to retain the benefits of the 936 program. The tourism sector should take note of reactions to the proposed "twin-bed" policy because it has implications for investment in the area.

Canada-Caribbean Relations

The scope and likelihood for modification of the provisions of the CARIBCAN to confer greater benefits on Caribbean countries will be hampered by diminishing Canadian interest in the region. Causes for this include Canada's economic downturn, which has caused reduced public support for economic assistance to other countries, in contrast to the support enjoyed by the Caribbean in the initial stages of CARIBCAN. The Canadian Parliament has also assumed a greater role in determining foreign policy and limited the powers of government. Relations with the European Community and Eastern Europe, Latin America, and the Asia-Pacific region are also receiving increasing attention. The ability of the Caribbean to influence Canadian action is diminishing.

Europe-Caribbean Relations

Developments on the domestic front demand increasing amounts of European funds and attention. Europe's recession also threatens to minimize attention to Caribbean needs and issues.

Trade Reform in Trinidad and Tobago

The 1980s saw Trinidad and Tobago setting up a highly protected trade regime that hampered diversification and made the manufacturing sector uncompetitive and highly dependent on protection. Domestic strategies that combined trade protection, restrictions on capital flows, price controls, and heavy subsidies hampered the growth of competitive agriculture, non-oil manufacturing, and tourism. These factors account for the inability of Trinidad and Tobago to take full advantage of the preferential trade it enjoyed with Canada, the United States, and Europe.

The governments of Trinidad and Tobago elected in 1986 and 1991 began to respond to the increasingly competitive nature of the international trade regime. They embarked on aggressive trade liberalization, with the nudging and support of the World Bank and the IMF.

Increasing emphasis on the private sector in existing preferential arrangements has been recognized in the context of those agreements. The private sector has gained additional importance in the context of a push to free trade.

Background

Trinidad and Tobago "enjoyed" a dominant oil sector that enabled the country to attain relatively high levels of development, but it caused severe distortions in the economy and produced substantial appreciation of the real exchange rate. Two surges in oil prices during the mid-1970s to early 1980s added to the buoyancy of the economy. Real GDP increased at an annual average rate of over 6 percent, with increases in foreign exchange reserves and increasing levels of imports. Per capita GDP peaked in 1982 at nearly $7,000 but dropped in 1988 to $3,350, due in large part to a sharp drop in oil prices. During that period, the country suffered a severe decline in its terms of trade.

In 1983, in response to the sudden decline in the terms of trade and oil revenues, the government introduced restrictive import licensing and exchange controls that sharply curtailed imports, but it was unable to halt the balance-of-payments shift to a deficit and foreign exchange reserves were depleted. In December 1985, the government devalued the Trinidad and Tobago dollar by 50 percent, from TT$2.49/US$1 to TT$3.60/US$1. In August 1988 a new exchange rate parity TT$4.25/US$1 was set, and in April 1993 the government moved to "float" the Trinidad and Tobago dollar and remove foreign exchange controls.

The Trinidad and Tobago Trade Policy Study: The Final Report

A number of critical issues were explored in the 1992 study on Trinidad and Tobago trade policy by Maxwell Stamp PLC. The major conclusions were:

- *Extra- and intraregional exports:* Where Trinidad and Tobago is internationally competitive in a particular good, it is likely that it would be exported to non-CARICOM markets subject to transport costs. Preferential access to the CARICOM market provides an opportunity to export at higher levels of profitability than applies to extraregional exports because of the protection given in the CARICOM market. This may provide scope for increasing the scale of production and the incentive of inward investment over exporting to outside the region only.

- *Antiexport bias and CARICOM:* If it is legitimate to view CARICOM as an extended domestic market for Trinidad and Tobago, then it is legitimate to view the high relative incentive to produce for this extended market rather than the extraregional market as being central to the issue of trade regime or antiexport bias. This interpretation of the relationship between the combined local and regional market and the extraregional market appears to have been confirmed by the experience of CARICOM. The smallness of the combined CARICOM market and the competitive nature of import-substitution policies across the region have meant that intraregional trade has generally grown slowly in both absolute and relative terms over the last two decades. At the same time, experience does gives scant support to the view that penetration of regional markets is a precursor to penetration of global markets. The limited extraregional export performance in nontraditional activities prior to trade reform of Trinidad and Tobago and most other CARICOM countries is more consistent with the view that regional import substitution policies constrained extrareqional exports.

- *Trade regime bias and export performance:* High levels of nominal and effective protection of import-substitute activities constitute a subsidy for import-substitution activities and are a significant source of antiexport bias. The costs of this import protection on export activities in Trinidad are identifiable from the true protection estimates provided. Negative true subsidy rates for export activities are evidence of implicit takes on exports resulting from import-substitution policies. Policy conflicts are associated with mixed trade strategies of the import substitution and export promotion. The "true" pattern of protection within the agricultural and manufacturing sectors is very different to the intended pattern.

- *Trade and industrial policy reforms:* The report identifies the short-term cost of unrestricted international trade in a small economy such as Trinidad and Tobago, and suggests that "long-term trade strategy should not be dominated, however, by concerns over the transitional costs of and constraints on reform. Rather, trade strategy should focus on the gains from greater exposure to international competition and from greater opportunities to export that would result from an outward- or export-oriented trade strategy.

Trade Liberalization

With the election of the government in 1986 came a number of important short- and medium-term reforms. These included unification of the two-tiered exchange rate. The 1988 devaluation of the TT$ to TT$4.25/US$1 contributed to a 6-percent improvement in the real exchange rate compared to its 1987 level.

The election of a new government in 1991 brought continuing trade reform consistent with agreements negotiated with the IMF and the World Bank.

Trade reforms under a World Bank structural adjustment loan focus on adapting incentives in favor of export production, with special emphasis on the removal of import licensing, replacement of quantitative import restrictions with tariffs, rationalization of the tariff structure, and facilitation of export activities. Trade liberalization has been marked by removal of items from the negative list.

IMF agreements called for liberalization of exchange restrictions and elimination of import licensing on 40 percent of restricted items. In 1991 the country experienced a 7-percent appreciation in the real exchange rate with respect to its 1976 level, and this development may be positively linked with relatively strong recent external terms of trade.

The government's acceptance of IMF and World Bank terms and recommendations with respect to trade liberalization were supported by a genuine recognition of past limitations and a strong determination to move toward free trade. After a series of stepwise constraint reductions starting in 1988, foreign exchange control was relinquished to the commercial bank and foreign exchange was liberalized in April 1993.

Most import payment restrictions have been lifted, and in 1989 export licensing requirements and import restrictions were removed from $150 million worth of agriculture products, petroleum and petroleum products, and some manufactures. The negative list was substantially reduced in terms of non-oil manufactures from January 1991 to the present. Quantitative restrictions were replaced by import charges of up to 100 percent in 1991. Tariff reform has been carried out, and a uniform value-added tax (VAT) replaced the sales tax

Increasing support to the private sector in terms of marketing and export facilitation has also been noted. But despite these reforms, total import tax rates continue to cause price distortion and reduce economic efficiency. Incentives to import substitution remain, and duty exemptions to inputs and capital equipment encourage the production of low-value-added goods. While incentives for production for the local and regional market exist, production for export to third countries still faces negative protection.

As a result of its accelerated internal reform, Trinidad and Tobago's trade relations with the United States and Europe have continued to be an important part of the country's economy, and important initiatives with respect to financing of trade with Latin American countries have recently been made by more than one banking institution in Trinidad and Tobago. Trinidad and Tobago's exports to Latin America have grown in recent years (Table 3).

The importance of exports to the EEC and the United States has fluctuated in recent years (Table 4). Exports to Canada in 1987 were approximately 1.75 percent of the total world trade. It has been estimated that approximately 96 percent of exports from Trinidad and Tobago enter the Canadian market duty-free under the CARIBCAN, MFN, British Preferential Tariff, and the GPT. In 1987, only 7.29 percent of those goods were exported under the CARIBCAN, a characteristically low share which is reflected by many of the Caribbean countries' exports to Canada.

The present Trinidad and Tobago government has continued to take concrete steps toward liberalizing its trade regime. One important step was liberalization of foreign currency restrictions. Prime Minister Patrick Manning, Chairman of CARICOM, has also expressed commitment to the integration process and proposed an economic union between Guyana, Barbados, and Trinidad and Tobago as a precursor to wider Caribbean integration. Strengthened ties with Latin America continue to be a priority, while ties with Europe have also received considerable attention.

Concluding Remarks

The Caribbean countries face a multitude of uncertainties in the rapidly changing international trade regime. One thing that is certain is that action will be required on their part to ensure that their participation, although already limited, is not further jeopardized by such developments. This will require increasing levels of competition that cannot be achieved in the short term, and certainly not without some form of protection. Protection for Caribbean industry to date has not lived up to expectations, in large part due to the failure of Caribbean countries fully to utilize their potential benefits with the aim of achieving higher market shares and levels of efficiency. What is required is a change in attitude, already in evidence albeit in response to extreme external pressures and the threat of economic pitfalls. The preferential regime will continue to play a vital, complementary role in the transition period in order to achieve, in the longer term, higher levels of human development for the Caribbean society.

International trade is characterized by change. Issues that will hold implications for Caribbean development arise daily. This document has attempted to present the major issues that require deep reflection and resolution in the immediate future. Action to be taken will require much further investigation, particularly with regard to the region's commitment to regional integration and accompanying domestic arrangements.

Table 3
Trinidad and Tobago Exports to Selected Latin American Countries
(millions of US dollars)

	1988	1989	1990	1991
Argentina	14.1	0.9	0.3	n.a.
Brazil	1.0	3.2	4.1	43.8
Chile	3.5	4.3	3.7	7.8[a]
Colombia	10.2	3.5	4.7	28.4
Costa Rica	5.4	3.2	1.4	2.6
Ecuador	0.6	0.7	3.5	9.4
Mexico	1.9	1.9	4.7	3.5
Venezuela	10.5	23.1	42.7	54.2
Total imports	47.2	40.8	65.1	149.7
World total	1,391.0	1,557.9	1,717.8	1,982.6
Percent of world total	3.4	2.6	3.8	7.6

n.a. = Not available
a. Six to 11 months of reported data, 1-6 months of estimates

Source: International Monetary Fund, *Direction of Trade Statistics Yearbook 1991*, Washington, D.C.

Table 4.
Exports to the EEC and the United States
($'000)

	1989	1990	1991
European Economic Community	135,500.8	171,168.2	180,439.3
Percent of world total	8.7	8.3	9.8
United States	854,247.8	1,145,124.7	966,168.5
Percent of world total	54.6	55.6	48.6
World total	1,563,397.2	2,059,613.2	1,986,898.5

Source: Central Statistical Office, Republic of Trinidad and Tobago, *Overseas Trade Report*

The LDCs of the region face critical issues that will have an impact on their development and will require the support of the other Caribbean countries in their resolution, and careful consideration when making regional approaches to new regimes.

In economic terms, our agenda for an integrated economy may focus on four pillars:

- The search for external (as opposed to internal) economies of scale,
- shaping of geographically compact economies,
- adoption of forward looking adjustment strategies, and
- measurement of the "range" of the Caribbean economy.

External Economies of Scale

The region's economic vulnerability is once again exposed in the EC/ACP banana dispute, the CBI argument over parity with NAFTA, the West Indian Commission's call for a deeper and wider Caribbean, and in the recent CARICOM-G3 (Colombia, Mexico, and Venezuela) summit meetings. At stake here is the search for external economies of scale for the region's productive capacity. The issue, however, is in what areas could external economies of scale be realized in a world that is less dependent on physical resources and not dependent on commodities. Some argue for the service sector, and others for the knowledge industries, while yet others emphasize the new technologies in information, engineering, and bioprocesses. In all cases, the conditions for external economies of scale must exist if this strategy is to be viable.

Compact Economies

Integration will be enhanced by a reduction in the cost of doing business. This economic behavior leads to geographically compact economies. In a world without trade barriers, these economic districts go beyond national boundaries.[7] Richard Bernal has pointed out that the apparel industry in Jamaica is vertically integrated with the United States textile industry, a link that will be broken at great cost to United States jobs and Jamaica's foreign exchange earnings, if parity between CBI and NAFTA is not achieved.

Compact economies are the result of changes in economic geography, and such changes are currently taking place in both North and South America. What will be the nature of the industrial districts of the twenty-first century? Could the Caribbean be an attractive location for strategic niches in the Western Hemisphere or in the world trading systems? In other words, could the region be a "hub" for specific industrial districts? These are questions that may inform the new agenda and ought to engage the corporate leadership's attention in the Caribbean Basin.

7. Major decisions on GATT, NAFTA, APEC, and SEM are still to be made and could raise the prospects of protectionism. Also nontariff, linguistic, and cultural barriers to free trade may introduce further protection.

Forward-looking Adjustment Policies

The structural adjustment policy debate has focused substantially on the sequencing of measures and a time period for adjustment policies to work, hence the call for time to adjust in order to prepare for the level playing field, the mitigation of social costs, the restructuring of production costs, and the switching of national expenditure. These assertions are all valid in their own right but, collectively, what is the new equilibrium after adjustment?

The evidence is clear: the Caribbean has had decades to adjust in the sugar and banana industries but has adjusted only to a persistent low equilibrium. The argument that more adjustment time will allow the Caribbean to prepare for the future is more likely to lead to the postponement of a new strategy and the recurrence of old situations. Forward-looking adjustment policies must focus on the targets of a new high equilibrium, and sequencing and timing should be determined on that basis. Otherwise, the Caribbean would be engaged indefinitely in the creation of "reality gaps" and the consequent politics of illusion.

Many of the countries in this region have adopted strong reform policy programs for macroeconomic stability and growth. In so doing, less attention has been placed on the microeconomic conditions essential for macro performance. For instance, instruments for export promotion such as duty-free access to imported inputs are sometimes viewed as a surrogate to exchange rate policy--without appreciating that exchange-rate policies change relative prices between the tradeable and nontradeable sector throughout the economy, and instruments for export promotion affect only the costs of specific industries. Qualitatively, according to Rajapatirana, exchange rate policy and export promotion measures are different and must be viewed as such. This illustrates the dichotomy between macro and micro conditions and draws attention to the need to identify and alter the microeconomic conditions for economic and social adjustment.

The Range of the Caribbean Economy

We are familiar with the "hub-and-spoke" argument that has been highlighted in the context of NAFTA and Latin America. Caribbean economies are seen as "spoke" in a United States-centered circle. Although not articulated in these words, the Caribbean-Europe links are similar, although there would be substantial differences in the nature of that link. Now that the region is in a disengagement period in both Europe and the United States, additional hurdles may arise. How might the Caribbean overcome these hurdles? Given its endowment, level of development, and the current environment, what is the realistic capacity for the region to enter into the mainstream of income-generating activities in the world economy? I call this the range of the economy.

Many small economies of East Asia have extended their range in production and trade dramatically, and they have secured an increasing share of world commerce. What are the conditions that allow such targets to be realized? Is it a question of Caribbean transnationals, or strategic public policy interventions, or a matter of Caribbean international relations? These and other issues could add to the composite measure, which we call the range of the economy, and so provide an insight that may lead to a new dynamic in the wider Caribbean economy that includes Cuba, the Dominican Republic, and Haiti.

The Agenda

This agenda points to clear objectives for an integration process in the region. It may at least persuade some to rethink the present approach. What is clear, however, is that the often-repeated cliché about the goals of integration are no longer illuminating. External economies of scale, compact economies, forward-looking adjustment policies, and the range of the Caribbean economy are areas that may advance the search for a twenty-first century integration paradigm. That never-ending search is on the rise again, and a synthesis of the ideas and current thinking would be timely, and could offer a valuable platform for a new respectability.

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THE SOCIAL ROOTS OF UNITED STATES PROTECTIONISM

Jeffrey W. Hayes
Seymour Martin Lipset

Introduction

This examination of the social roots of American protectionism reviews the sources of social pressures that have produced—and continue to create—barriers to free trade. Most students of trade policy have sought to isolate the variables that contribute to protectionism. Generally, these explanations emphasize either domestic or international factors. Critics have noted that the predictive accuracy of both types of model has been unimpressive. This essay, however, does not seek to prognosticate, but to describe and explain the important actors and ideas that have promoted different trade orientations in American history.

A brief survey of American economic history will clarify that protectionism has not merely been a matter of economics *or* political lobbying and pandering. The relative openness of the economy has been related in important ways to the interaction of the society's political culture and the political system itself. Paradoxically, within that culture, which can be called the American Creed, lie the ideological sources of divergent trade orientations—on the one hand, the largely uninterrupted protectionism of the first 150 years of the republic and, on the other, the United States' post-World War II international role as a leader of the liberal trading regime. This paper seeks to explain these apparent contradictions using the theoretical tools of current trade policy analysis as well as the authors' own analysis of the importance of national ideology in shaping foreign economic policy.

American Political Culture[1]

Born of revolution, the United States is a country organized around an ideology that includes a set of dogmas about the nature of a good society. Americanism, as different people have pointed out, is an "ism" or ideology in the same way that communism, or fascism, AND liberalism are "isms." Richard Hofstadter noted, "it has been our fate as a nation not to have ideologies but to be one."[2] Or as G. K. Chesterton put it, "America is the only nation in the world that is founded on a creed. That creed is set forth with dogmatic and even theological lucidity in the Declaration of Independence...."[3] The nation's ideology can be subsumed in four words: antistatism, individualism, populism, and

1. This section has been adapted from the forthcoming book by Seymour Martin Lipset, *American Exceptionalism Reaffirmed.*

2. Quoted in Michael Kazin, "The Right's Unsung Prophet", *The Nation,* February 20, 1989, p. 242.

3. G. K. Chesterton, *What I Saw in America* (New York: Dodd, Mead and Company, 1922), p. 7.

egalitarianism. The revolutionary ideology which became the American Creed is liberalism in its eighteenth- and nineteenth-century meanings.[4]

Other countries derive their sense of themselves from a common history, not an ideology, and if they have a historic set of conservative political values, it is Toryism, statist communitarianism, *noblesse oblige*. Winston Churchill once gave vivid evidence to the difference between a nation rooted in history and one defined by ideology in objecting to a proposal in 1940 to outlaw the antiwar Communist Party. In a speech in the House of Commons, Churchill said that as far as he knew the Communist Party was composed of Englishmen and he did not fear an Englishman. In Europe, nationality is related to community, and thus one cannot become un-English or un-Swedish. Being an American, however, is an ideological commitment. It is not a matter of birth. Those who reject American values are un-American.

The American Revolution sharply weakened the *noblesse oblige*, hierarchically rooted, organic community values that had been linked to Tory sentiments, and it enormously strengthened the individualistic, egalitarian and antistatist ones. This is evident in the fact that the United States, as H. G. Wells pointed out over 80 years ago, not only has lacked a viable socialist party, it also never developed a British- or European-type conservative or Tory party. Rather, America has been dominated by pure bourgeois, middle-class individualistic values. As Wells put it: "Essentially America is a middle-class [which has] become a community and so its essential problems are the problems of a modern individualistic society, stark and clear." He enunciated a theory of America as a liberal society—in the classic antistatist meaning of the term—that was to win wide acceptance a half-century later when described in more detail by Louis Hartz:

> It is not difficult to show for example, that the two great political parties in America represent only one English party, the middle-class Liberal party.... There are no Tories...and no Labor Party.... [T]he new world [was left] to the Whigs and Nonconformists and to those less constructive, less logical, more popular and liberating thinkers who became Radicals in England, and Jeffersonians and then Democrats in America. All Americans are, from the English point of view, Liberals of one sort or another....
>
> The liberalism of the eighteenth century was essentially the rebellion...against the monarchical and aristocratic state—against hereditary privilege, against restrictions on bargains. Its spirit was essentially anarchistic, the antithesis of Socialism. It was anti-State.[5]

The United States, almost from its start, has had an expanding economic system. The nineteenth-century American economy, as compared to the European ones, was characterized by more market

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4. Louis Hartz, *The Liberal Tradition in America,* (New York: Harcourt, Brace and World, 1955), pp. 6, 234. The word liberal, it should be noted, did not come into existence until the early 19th century and probably did not take on this meaning until the middle. See Giovanni Sartori, *The Theory of Democracy Revisited, Part Two: The Classical Issue* (Chatham, NJ: Chatham House Publishers, 1987), pp. 370-1.

5. H. G. Wells, *The Future in America* (New York: Harper and Brothers, 1906), pp. 72-76. For an excellent analysis of liberal party politics in Britain, Canada, and the United States, see Robert Kelley, *The Transatlantic Persuasion: The Liberal-Democratic Mind in The Age of Gladstone* (New York: Alfred A. Knopf, 1969).

freedom, more individual land ownership, and a higher wage income structure—all sustained by the national classical liberal ideology. From the Revolution on, it was the *laissez-faire* country *par excellence.* Unlike the situation in many European countries in which economic materialism was viewed by the traditional aristocracy and the church as conducive to vulgar behavior and immorality, in the United States hard work and economic ambition were perceived as the proper activity of a moral person.

Writing in the 1850s, a visiting Swiss theologian, Philip Schaff, commented that the "acquisition of riches is to them [the Americans] only a help toward higher spiritual and moral ends."[6] Friedrich Engels and Max Weber, among many, emphasized that the United States was the only pure bourgeois country, the only one which was not postfeudal.[7] As Weber noted, "no medieval antecedents or complicating institutional heritage [served] to mitigate the impact of the Protestant ethic on American economic development."[8] Similar arguments were made in the 1920s by the gifted Italian communist theoretician Antonio Gramsci.[9] America was able to avoid the remnants of mercantilism, statist regulations, church establishment, aristocracy, and the emphasis on social class that the postfeudal countries inherited. All of these writers emphasized America's unique origins and resultant value system as a source of its economic and political development. Its secular, *laissez faire,* liberal orientation was integrally related to various aspects derivative from its special religious tradition, the dominance of the Protestant sects that Weber emphasized facilitated the rise of capitalism.[10]

In 1992, we logically associate the free market with free trade. Yet America's strongly liberal tradition somehow produced a foreign economic policy which relied upon restrictive protectionist measures until the midtwentieth century. Britain had already built a prosperous, dominant trading empire by the time that Americans even began to contemplate the relationship between economic growth, export markets, and low trade barriers. What explains this apparent contradiction between culture and policy? The answer to this question begins with a survey of America's protectionist trade policies.

6. Philip Schaff, *America: A Sketch of the Political, Social, and Religious Character of the United States of North America* (New York: C. Scribner, 1855), p. 259.

7. Engels to Sorge (February 8, 1890) in *Marx and Engels, Selected Correspondence, 1846-1895* (New York: International Publishers, 1942), p. 467.

8. Max Weber, *The Protestant Ethic and the Spirit of Capitalism* (New York: Scribner, 1935), pp. 55-56.

9. Antonio Gramsci, *Selections from the Prison Notebooks* (New York: International Publishers, 1971), pp. 21-22, 272, 318.

10. Weber, *The Protestant Ethic,* pp. 155-183; and Max Weber, "The Protestant Sects and the Spirit of Capitalism," in *Essays in Sociology,* trans. by Hans Gerth and C.W. Mills (New York: Oxford University Press, 1946), pp. 309, 313.

Protectionism in America

The Founding and Antebellum Tariff Policy

Though the United States was born a liberal society with a strong antistatist orientation, government intervention in the form of tariffs was the norm from the beginning. One of the first official acts of the Continental Congress in 1789 was the imposition of a tariff, a 5-percent duty on all imports except some manufactured goods, which had rates of up to 15 percent. Since the Constitution forbade export taxation, this modest import tax was the principal source of revenue for the federal government. Debate over early U.S. trade policy was heated: Jefferson and other Southern agrarians urged low tariffs to keep import prices down (so that they could export their farm products and buy manufactured goods cheaply from abroad) while Hamilton and a faction representing Northern manufacturing interests argued for higher tariffs to protect what he called, "infant industries." Though Hamilton's 1791 "Report on Manufactures" was brandished by later advocates of protectionism, it had little actual effect on these early policy debates.[11]

The legal bases of American trade policy can be found in Article I, Section 8 and Article II, Section 2 of the Constitution. Administering trade laws became the traditional domain of Congress, which was constitutionally mandated to "regulate commerce with foreign nations..." and "lay and collect...duties." But treaty negotiation—which would later be an important means for the reciprocal reduction of trade barriers—was left to the executive branch: "[The President] shall have power, by and with the advice and consent of the Senate, to make treaties, provided two-thirds of the Senators present concur..." Both branches of government had some de jure power over trade policy. Different points in history produced very different kinds of policies, and the difference depends on which branch was exercising power at the time.

The earliest U.S. tariff was not a prohibitive trade restraint relative to other countries at the time. In fact, it could hardly be called a "trade policy" since there was limited political and economic rationale behind the duties. The federal government needed a steady source of revenue, and import duties were one of the few options at the time.

It took a series of events that culminated in the Tariff of 1816 to bring to light the importance of the openness of the American economy. The War of 1812 and the preceding British embargo of December 1807 had stimulated the iron foundries of Pennsylvania and the textile mills of New England, and with peace came calls for continued protection for these young industries. Even Jefferson came to favor protectionism after witnessing the disruption wrought by 15 years of British predatory trading and embargo. He viewed America's fledgling manufacturing base as vital to the country's continued independence.[12] The 1816 tariff put a virtual choke-hold on imported woolen, cotton, and iron manufactures.

11. Sidney Ratner, *The Tariff in American History* (New York: D. Van Nostrand, 1972), p. 12.

12. Thomas Jefferson's letter to Benjamin Austin, 9 January 1816 in Merrill D. Peterson, ed., *The Portable Thomas Jefferson* (New York: Viking Press, 1975), pp. 547-550.

Tariff levels oscillated up and down until the Civil War, though duties, on average, remained at relatively modest levels during this period. Tariffs were increased in 1824[13] and again in 1828, but this latter tariff, the "Tariff of Abominations," produced widespread public disaffection with the artificially high prices of some goods. Average ad valorem tariff rates stood between 45 percent and 50 percent on most imported goods. Tariff reductions soon followed and returned the average rate to around 30 percent until the depression of 1837-1842, which convinced many Whigs (many of whom would later comprise the Republican party) that trade barriers were essential to the country's economic development and self-sufficiency.

It is not surprising that there were no calls for "free trade" in the early years of the republic. One of the more powerful Congressional opponents of early protectionist legislation was Daniel Webster of Massachusetts.[14] But while he argued the case against "prohibitive" tariffs, he, like most national leaders, supported "moderate" tariffs. The tariff question was one of how high, not whether or not to enact them.

Postbellum America and Republican Leadership

Before the Civil War, tariffs mainly served (and were politically justified) as a source of revenue for the federal government. They were not prohibitive relative to other trading nations of that era. The fledgling economy continued to grow during this period with an emphasis toward the domestic home market, which was viewed as a dependable and sufficient source of demand for U.S. products. Incentives for the export of American goods, however, increased substantially after the war. Annual antebellum trade averaged $116 million in the years from 1838 to 1849 while between 1850 and 1873 exports averaged $274 million. And by 1893, America was second only to Britain in total exports.[15] In the 1880s, American farmers helped to change the economic relationship between the United States and Europe as grain exports skyrocketed, challenged European producers, and made the United States a significant new presence in international markets.

Yet, even as Great Britain moved to create a liberal international trading system from the 1840s onward, the United States did not follow the liberalization trend. U.S. tariffs were either left intact or raised, and the United States basically ignored the relationship between open markets abroad and similar treatment for European goods in American markets. Three factors were essential. First and most important, the American tariff was considered a domestic policy issue by politicians and the public alike. The twin imperatives of revenue and national economic independence made U.S. trade policy an internal matter. Reciprocal tariff reductions with trading partners were not even a policy option. Second, the Civil War had generated intense fiscal pressures for increased government revenue. The costs of the war, to a large extent, were absorbed by new and higher tariff barriers. Third, the Civil War had the additional impact of temporarily transforming America's federal government into a one-party system.

13. The general average tariff at this time was about 30 percent.

14. Webster ultimately reversed his position, however, and joined the pro-tariff forces beginning with the 1828 tariff.

15. C.J. Bullock, J.H. Williams, and R.S. Tuckner, "The Balance of Trade of the United States," *Review of Economics and Statistics*, 1 (July 1919), pp. 215-266.

After the war, the Republicans, associated with Northern, protectionist business factions, assumed control over Congress and the presidency for most of the period from 1860-1874. This party's generally pro-tariff stance dampened any prospects for reduced trade barriers. The Democrats were finally resuscitated when they gained control of the House following the depression of 1873. It was not until Grover Cleveland and the election of 1884 that a Democrat made it to the White House.

In the antebellum period, politicians were hesitant to use the tariff issue as a point of contrast with their political opponents. Few wanted to be pegged as extremists on either end of the trade spectrum, whether "protectionist" or "free trader." Andrew Jackson, a Democrat and a proponent of low tariffs, ran from the issue during his tenure as president: he sought to avoid the uncertain consequences of staking out a clear position on the trade question. In addition, these years were marked by greater fluidity in Congressional voting patterns on tariffs. Regional and party coalitions on both sides of the protectionist debate had not then solidified.

Following the war, the tariff gradually assumed greater prominence in the political arena and became a tool for the unification of diverse constituencies and political actors. "The tariff issue was of such importance in this period that there were times when it was the only major campaign issue..."[16] As Tom Terrill notes, party positions on the tariff became starkly defined:

> Protectionism, which had been politically expedient in the 1860s, now became party dogma.... By the election of 1880 protectionism virtually equalled Republicanism. The Democrats later assumed an opposite position. The Republican choice was both natural and forced upon them. The GOP, which included champions of industrialization and the spiritual heirs of Hamilton and Clay among its strongest factions, naturally took up protectionism.[17]

Tariff rhetoric was a cheap commodity for late nineteenth-century politicians, for whom it was less divisive than other national concerns of the time. It countered "the centrifugal forces of sectionalism, ethnic and religious differences, dynamic but uneven economic change, or perspectives limited by the boundaries of a neighborhood or small community."[18] Trade barriers were the focal point of national politics when President Grover Cleveland, a Democrat, devoted an 1887 message to Congress to criticism of that holdover from the Civil War, the high protective tariff. The election of the following year pitted Benjamin Harrison against Cleveland and continued the battle over Democratic and Republican tariff positions. With Harrison's victory, Congress was able to enact the quite restrictive McKinley Act in 1890. Cleveland was elected again in 1892 and the Wilson-Gorman Act of 1894 instituted modest tariff reductions.

It is important again to note that the tariff debates of the nineteenth and the early twentieth centuries were arguments of protection versus *tariff reduction*. Free trade, even as an ideal, was hardly

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16. Robert A. Pastor, *Congress and the Politics of U.S. Foreign Economic Policy, 1929-1976* (Berkeley: University of California Press, 1980), p. 75.

17. Tom E. Terrill, *The Tariff, Politics and American Foreign Policy* (Westport, CT: Greenwood Press, 1973), p. 25.

18. Ibid., p. 9.

considered. The Democrats, known largely as the antitariff party, advocated "a tariff for revenue only," not liberal free trade, in their party platforms of the 1876 and 1880.[19] In a debate over the proposed Mongrel Tariff of 1882, Congressman William M. Springer stated that "the real issue presented to the country in this debate has been greatly misunderstood or willfully mistated. It is not between free trade and protection. I know of no party in this country or in this House who proposes free trade as a remedy for existing tariff abuses."[20] And even Cleveland's vicious attacks on the tariff during the 1888 election fell far short of advocating free trade.

The reason for the lukewarm calls for unrestricted trade lies partly in the fact that the intellectual argument for free trade was unsophisticated at this time. By the 1870s, the Democrats had "reduced their trade theories to one misleading quantitative theory: since foreign trade is essentially barter, countries tend to trade in similar amounts."[21] Ricardo's theory of comparative advantage had not then achieved a dominant position in American economics. Each side—protection and tariff reduction—had its advocates in academia. And even when the laissez-faire trade theory became predominant, it was still misused and misunderstood by policy makers.

Regardless of their grasp of economics, most policy makers realized the potential benefits of open foreign markets for American exports. Oddly enough, many believed that there was no contradiction in instituting high barriers for entry into the U.S. market and demanding low barriers abroad. As one magazine of the time put it, "Protectionists and free traders seem to have at last arrived at a common point as both classes now profess to be desirous of enlarging our foreign trade. They are, of course, not in harmony with each other as to the means to be adopted in securing this purpose."[22] Similarly, "...*Export and Finance* noted in 1889 that, although the country was filled with self-styled 'isolationists,' it was impossible to find a single person who did not favor increased commercial entanglements."[23]

William McKinley, who became president in 1897, clearly symbolized the strange paradox of American thinking on trade policy: a narrow, domestic orientation coupled with an emphasis on new outlets for American production. He was a staunch Republican protectionist while at the same time, like a true free trader, aware of the importance of open foreign markets by which to take advantage of the country's growing export potential. Though the combination may appear contradictory, it was consistent and logical in late nineteenth-century America. Tariffs were considered domestic policy actions; their impact on America's trading partners were thought to be incidental. The year that McKinley took office, a Republican-controlled Congress passed the restrictive Dingley Tariff Act that returned tariffs to the levels of the 1890 Act. McKinley later turned his attention to reciprocal trade agreements, an authority delegated by Congress in the Dingley Act, by which he hoped to expand America's overseas trade. In

19. Kirk H. Porter and Donald Bruce Johnson, *National Party Platforms, 1840-1964* (Urbana: University of Illinois Press, 1966), pp. 50, 56.

20. Quoted in Terrill, *The Tariff,* p. 66.

21. Ibid., p. 34.

22. *Iron Age,* "Reciprocity Treaties," October 9, 1890, p. 599.

23. Ibid., pp. 60-61.

the coming years, eleven trade treaties were negotiated, but all failed to be ratified by the Senate.[24] McKinley's attempts to make the United States economically independent and at the same time a prosperous trading nation demonstrate the strange mix of theoretical justifications for protectionism in America.

To many observers the 1890s were a brief exception to the high tariff norm of the United States in the nineteenth century. However, though the Wilson-Gorman Act of 1894 instituted modest tariff reductions, the Dingley Tariff of 1897 returned tariffs to the levels of the restrictive 1890 McKinley Act. The turn of the century brought a continuation of protectionism. The Payne-Aldrich Tariff of 1909 raised import duties to their highest level in American history prior to the First World War. But public clamor over the high prices of certain goods made tariff reform likely. The Republicans fared badly in the Congressional elections of 1910 and 1912, and the low-tariff forces won sufficient votes to pass sweeping reductions in the 1913 Underwood-Simmons Tariff Act.

The Underwood-Simmons Act, signed by Woodrow Wilson, was not merely one more shift in the seemingly endless political tug-of-war over the tariff. It laid the foundation for the gradual weaning of the United States from the tariff as its major source of revenue. The Underwood Act included provision for an income tax, a power granted the Federal Government by the Sixteenth Amendment to the Constitution, ratified in 1913. This movement toward a progressive system of taxation eventually helped shift the debate over tariff levels. Previously, bad economic times brought calls for higher tariffs to protect slumping American producers and increase government revenues. After the institution of the income tax, protectionists had only the first rationale on which to rely. And considering the Democrats' traditional slogan, "a tariff for revenue only," pro-tariff forces found even fewer allies in the Democratic party. This institutional change in the composition of government revenue had a subtle and gradual effect on the persistent and important tariff question. It was not a coincidence that major reductions in U.S. tariffs occurred in the post-World War II era when, by the late 1960s, tariffs accounted for less than one percent of Federal Government revenue.

The Interwar Years

Though Wilson's Fourteen Points called for the "removal, so far as possible, of all economic barriers...", his inclination toward internationalism and free trade had limited impact on a Congress and a society accustomed to tariff protection as the norm. The end of the First World War brought calls for disentangling the United States from European affairs. The national mood was clearly inward-looking rather than outward-looking. Hopes for tariff reduction rose and fell with the cycle of Democratic and Republican administrations, but protectionism remained entrenched. William Kelly has noted:

> Before 1860 the United States tariff was relatively moderate. Rates were increased during the Civil War, and they continued to rise during the latter part of the nineteenth and early part of the twentieth centuries. The only significant deviation from this long-

24. This authority was revoked in 1909 in favor of a "flexible tariff" which sought to equalize production costs between U.S. firms and foreign ones, thereby effectively mandating the cancellation of comparative advantage. The flexible tariff was a Republican favorite up to Hoover but it failed in practical as well as theoretical terms. The Tariff Commission succeeded in drawing up reports on only 38 items between 1922 and 1930; in all but five cases, the President raised the tariff levels.

term upward movement was the Underwood-Simmons Act of 1913, in which the Wilson Administration attempted to reverse the direction of United States policy and return to a tariff for revenue only, the traditional position of the Democratic party.[25]

The Fordney-McCumber Tariff of 1922 was signed into law under a Republican-controlled Congress and presidency. The rationale for these tariff increases resembled that used after the War of 1812: infant industries stimulated by the war needed protection to survive. This act ended nine years of relatively low tariffs and signaled America's unwillingness (inability?) to assume the mantle of free trade leadership that Great Britain was rapidly finding onerous as its economic might declined.

An examination of the groups within American society represented by the Republicans helps illuminate the continuing vitality of the pro-tariff forces into the twentieth century. Throughout much of the 1800s, Republicans aligned themselves with the growing manufacturing sector, but toward the turn of the century these same businesses were the target of widespread public ire, portrayed as monopolistic trusts preying upon small business and the consumer. The 1890s were an era of "trustbusting," and high tariffs were seen as the creatures of monopoly interests. This sentiment continued to influence national politics into the twentieth century and was a factor in the significant reductions of the 1913 Underwood Tariff. "Trustbusting" became a national campaign against unfair business practices that were seen as threatening. During this period many Republicans attempted publicly to cement strong ties to small and medium-sized manufacturers, popularized as the driving force behind the American economy. It was not a coincidence that this group of interests favored the Republicans' traditional pro-tariff platform. While some larger firms had already begun to recognize the benefits of foreign sales, small businesses were most likely to emphasize the importance of the domestic American market. The Republicans' alliance with the inward-looking small-business sector provided that party's protectionist platform with (perhaps undeserved) longevity through the 1950s.

Before World War II, tariff changes were possible mostly through regional coalitions of lawmakers in Congress. The earliest prohibitive tariff, passed in 1816, was passed by a coalition of agrarian interests of the North and West and Northern industrialists, and they defeated an alliance of Southern planters and Northeastern merchants. The situation changed little over the following hundred years: Northern and Midwestern manufacturers supported high tariffs, Southern farmers opposed protection, and Midwestern agriculture was split by the prospect of lucrative grain exports and the fear of cheap farm imports. But in the 1920s and 1930s Western manufacturers began to find export markets for their products, and the South saw the growth of an indigenous textile industry that required protection. The composition of the national economy fundamentally changed, and the needs of different constituencies also changed, though politicians in Washington were often slow to realize the ramifications in policy terms.

Herbert Hoover, arguably one of these politicians, campaigned for the presidency in 1928 on a high tariff platform, a response to agricultural interests plagued by low prices throughout the 1920s. He promptly got his way as a tariff bill rolled through Congress in 1929. The Smoot-Hawley Tariff, as E. E. Schattschneider's brilliant study showed,[26] was a classic instance of Congressional log-rolling that

25. William B. Kelly, Jr., "Antecedents of Present Commercial Policy," in William B. Kelly, Jr., ed., *Studies in United States Commercial Policy* (Chapel Hill: University of North Carolina Press, 1963), p. 3.

26. See Elmer Eric Schattschneider, *Politics, Pressures and the Tariff* (New York: Arno Press, 1974 reprint).

produced tariff schedules for over 20,000 items and an average ad valorem tariff rate on dutiable imports of 52.8 percent—a level higher than at any other time in the twentieth century. The final bill took 14 months to pass through Congress, in no small part due to the 1,253 amendments added to it in the Senate.

Like many national leaders before him, Hoover viewed the new tariff purely as a domestic issue and seemed oblivious to the ensuing retaliation by virtually every U.S. trading partner. Nations around the world, especially in Western Europe, relied upon the United States as the world's largest creditor nation and a crucial export market. Without this market and favorable balances of trade, they were hard pressed to meet their World War I debt payments. "Defensive" tariffs were thus forced upon many of these trading nations to stem deflation and economic instability. World trade, and with it the American economy, spiraled downward.

Even at this point in history, free trade as an ideology found few proponents except zealots like Cordell Hull, Secretary of State in Franklin Roosevelt's administration. Tariffs were considered legitimate prizes that legislators doled out to their constituencies, heedless of their impact on the international marketplace. Schattschneider quoted one senator who justified tariffs as a Constitutional right: "The government cannot deny the equal protection of the law to any of its citizens."[27] On the other side of the issue, those who opposed Smoot-Hawley could hardly be called ardent free traders: "The opposition was put into the position of arguing against individual duties...on the grounds that exceptions to the general policy should sometimes be made."[28] Though more than a thousand economists signed a letter urging Hoover not to sign the tariff into law, their reasoning had yet to permeate national economic strategy.

Hoover remained adamant in his isolationist defense of high tariffs through 1932 when he vetoed a lower tariff, arguing that "[t]he first legislative act of Washington's administration was a tariff bill. From that day to this, one of our firm national policies has been that tariffs are solely a domestic question...."[29] Remarkably, the Republican party continued to advocate the protective tariff.

Though Roosevelt and not a few Congressional Democrats were initially ambivalent in their support of free trade, Cordell Hull was not. His fanaticism on the issue of free and open trade helped gain passage of the Reciprocal Trade Agreements Act in 1934, a law that most students of American trade policy view as a watershed in the country's economic history. Passed under a Democratic president by a Democratic Congress, the act shifted responsibility for trade policy from the legislative to the executive branch and allowed the president to negotiate foreign trade agreements to reduce U.S. tariffs by as much as 50 percent; Congress required renewal of this authority every three years. Between 1934 and 1947 29 agreements were concluded and, because of the adoption of the unconditional most-favored-nation (MFN) policy in 1923, tariffs were broadly reduced to an average of 25 percent during these years.

The unconditional MFN rule was essential for the success of these initiatives. The embrace of unconditional MFN essentially meant that trade concessions granted to one country would be

27. Schattschneider, *Politics, Pressures and the Tariff*, p. 92.

28. Ibid., p. 142.

29. William S. Myers and Walter H. Newton, *The Hoover Administration: A Documented Narrative* (New York: Charles Scribner's Sons, 1936), p. 494.

automatically granted to all other trading partners, thereby assuring equity, uniformity, and nondiscrimination. Though unconditional MFN had always been the international norm, America resisted the multilateral dimension implicit in the policy and opted for conditional MFN, which entailed reciprocal bilateral agreements and, necessarily, discrimination. The 1923 decision to embrace unconditional MFN represented a de jure reversal of a long-standing U.S. position. In fact, however, the United States' interpretation of conditional MFN rarely resulted in discrimination against trading partners because so few trade agreements were ever negotiated and successfully implemented. It was only after the 1934 Act that this policy became integral to liberalization efforts.

It is important, however, not to overstate the certainty and speed of trade policy change. We cannot mark a specific year when America embraced free trade. For instance, included in the Reciprocal Trade Agreements Act was what came to be called the "escape clause" that allowed the president to reinstate the previously dismantled trade barriers if an industry could prove "serious injury" as a result of the absence of those barriers.[30] The passage of the Act did not immediately signal an opening of America's markets; it was only a first, and somewhat uncertain, step toward the institutionalization and realization of a liberal trade regime.

Hegemony

A liberal trading system was not assured after the Second World War. Indeed, the lesson of World War I was that isolationism followed on the heels of protracted international engagements. President Roosevelt was determined not to allow that course of events to repeat itself. As early as 1941, he and Winston Churchill "drafted an Atlantic Charter that laid down broad principles for the establishment of a liberal economic system after the war."[31] The key institution in the creation of such an order was to be the International Trade Organization (ITO). The ITO, however, never even reached the Senate for ratification. Instead, the State Department concluded the General Agreement on Tariffs and Trade (GATT). Negotiated in 1947 to be a part of the permanent ITO, GATT became the forum for future multilateral trade talks.

However, free trade was not the assured international economic system even after the United States assumed the mantle of hegemony. With the fall of communism and the growing international popularity of laissez-faire economic principles in the 1990s, it is easy to forget that classical liberal economic theory was not always in vogue. After World War II, central planning was considered in many economic and political circles to be the next step in the evolution of modern industrial society. In 1946, Jacob Viner gloomily described "The Prospects for Foreign Trade in the Post-War World":

> The growth of the doctrine and practice of national economic planning and the experiences and experiments of the Great Depression have led many persons to look with an unfriendly eye on foreign trade, with its intractability to the disciplines of national

30. However, this safety-valve has not been an important protectionist lever in the post-World War II era because the power to exercise the escape clause continues to rest with the executive which has been traditionally more free trade oriented.

31. Charles Kindleberger, "U.S. foreign economic policy, 1776-1976," *Foreign Affairs*, 55 (January 1977), p. 406.

Five-Year Plans. Even British economists reared in the free-trade tradition have come to write down the benefits that flow from foreign trade and to attach so much weight to its risks and inconveniences and disorderliness as seen from the point of view of the national planner that they welcome any natural tendencies toward autarky and either definitely advocate positive reinforcement by government for such tendencies or condemn it in such mild and hesitant terms as for practical purposes to amount to the same thing.[32]

By some measures, U.S. policy makers were hesitantly pursuing freer trade even in the mid-1950s, when U.S. economic power was perhaps at its zenith. The Trade Agreements Extension Act of 1955 "was equivocal toward the policy [of free trade], full of compromises, and meager in its grant of authority."[33] On the other hand, even though the act included restrictive amendments, this was the first time that a Republican administration strongly endorsed freer trade.[34] Eisenhower's two-term presidency was marked by a commitment to internationalism in foreign policy and trade policy. Bipartisan support for fewer restraints on trade helped forge a consensus on the virtue of free trade.

The United States is hardly unique in ignoring economic wisdom for the sake of political expediency. Though Ricardo developed his theory of comparative advantage in 1817, his insightfulness obviously did not guarantee free trade a place in American trade policy. Though it is tempting to consider the historical evidence that "policy makers are dense," Stephen Krasner rightly points out that "stupidity is not a very interesting analytic category."[35] We must turn to other, more rigorous explanations for the protectionist streak in American history and for the emergence of a free trade consensus after World War II.

Fred Bergsten has noted, "[t]he economic argument was never sufficient by itself...to support a liberal trade policy for the United States."[36] Indeed, the economic argument was not compelling until World War II because of the relative unimportance of trade to the country's economic growth. Foreign grain sales became important in the 1880s, but before *and* after that, the debate centered around how to protect the United States' "home market." Even in 1985, exports accounted for only 7 percent of America's GNP, compared to 25 percent for EEC countries.

Bergsten argues that postwar anticommunism was a major motivating factor in the United States' active promotion of a liberal international economy. As President Eisenhower said in his message to Congress of March 20, 1954, "[f]or our own economic growth we must have continuously expanding world markets; for our security we require that our allies become economically strong. Expanding trade

32. Jacob Viner, *International Economics* (Glencoe, IL: The Free Press), p. 310.

33. Harry C. Hawkins and Janet L. Norwood, "The Legislative Basis of United States Commercial Policy," in Kelly, ed., *Studies in United States Commercial Policy,* p. 110.

34. Ibid., pp. 111-112.

35. Stephen Krasner, "State Power and the Structure of International Trade," *World Politics,* 28 (April 1976), p. 319.

36. C. Fred Bergsten, "Crisis in U.S. Trade Policy," *Foreign Affairs,* (July 1971), p. 620.

is the only adequate solution for these two pressing problems confronting our country."[37] Bergsten also notes that "one of Kennedy's main arguments for the Trade Expansion Act was the need to counter the 'communist aid and trade offensive,' and the theme of anticommunism ran throughout the message in which he proposed it."[38]

Anticommunism clearly influenced American efforts toward trade liberalization, but, more important, it was reflective of a larger shift in U.S. politics from inward-looking unilateralism to outward-looking internationalism. Truman, Eisenhower, and Kennedy were internationalists, leaders who helped define America's superpower role. They shaped a foreign policy that actively sought out entanglements in the industrial and developing worlds to ensure friends in what they saw to be a world increasingly subject to communist domination and the "domino effect."

American foreign policy has traditionally emphasized indirect influence or presence guarantee access rather than direct interference in other countries' affairs.[39] Open commerce was one of the United States' most effective tools in constructing this network. That is not to say that the United States would not bring to bear tremendous pressures on foreign countries to secure its interests, but America did not seek out the responsibility of permanent territorial gains and thus was never an "empire" in the vein of Britain, France, Spain, Portugal, or the Netherlands. Considering this tradition, it is not surprising that trade became a centerpiece of American internationalist foreign policy. U.S. policy makers did not wish to create an alliance system so much as an ideological web of countries concerned about the same thing: communist aggression. Free trade was not only a strategy for domestic economic strength but also a political initiative reflecting a new commitment to the international system.

The Trade Expansion Act of 1962, signed by John F. Kennedy, was arguably the apex of openness and represented the fullest embrace of free trade principles in American history. The act expanded the president's authority to reduce and even eliminate American tariffs. Further, the Kennedy Round of trade negotiations produced substantial tariff reductions: "Tariff concessions of about $40 billion in trade were exchanged among participating countries; tariff reductions of 50 percent were made on many nonagricultural products...."[40] U.S. tariffs were ultimately reduced to between 8 percent and 9 percent through this round.

It was also in the post-World War II period that pro- and anti-tariff sectional alliances continued to lose importance. Though some members of Congress (such as Senator Robert Taft of Ohio) disregarded fundamental changes in the economic composition of their districts, the traditional coalitions no longer formed cohesive voting blocs. Northern manufacturing interests saw the benefits of open export markets with few strong competitors, and Southern agriculture had already moved from selling

37. "Recommendations concerning foreign economic policy," *The Department of State Bulletin*, XXX (April 19, 1954), p. 607.

38. Bergsten, "Crisis in U.S. Trade Policy," p. 626.

39. Samuel P. Huntington, "Transnational Organizations in World Politics," *World Politics*, 25/3 (April 1973), pp. 343-345.

40. Matthew J. Marks and Harald B. Malmgren, "Negotiating nontariff distortions to trade," *Law and Policy in International Business*, 7 (1975), p. 328, ftn. 5.

raw materials to producing finished products. The sector would eventually be threatened by low-wage foreign firms.

Protectionism, however, had such a long tradition in American politics that it could not be fully purged. In 1961, just one year before the very productive tariff-cutting Kennedy Round and passage of the Trade Expansion Act which (it should be noted) was passed only after a fierce fight by the president, noted economist Jacob Viner issued this warning: "It is obvious, however, that there is keen awareness on the part of the president of the fact that in Congress, at least, and perhaps also in the country at large, the tide is running in a protectionist direction...."[41] In new trade legislation, many of the old safeguards remained in the form of "peril points" and "escape clauses." The former served to protect domestic industries from harm caused by pre-existing trade agreements, and the latter limited concessions that might cause injury in future agreements.

After Hegemony: The 1970s and 1980s

Signs of waning American economic dominance in the international marketplace began to appear in the 1960s, with significant pressures for policy change arriving in the 1970s. The United States' first trade deficit in the twentieth century came in 1971. In addition, the percentage of personal consumption expenditures for imports in the 30 years after World War II increased from 5 percent to 14 percent by 1984. Charles Kindleberger observed in 1976, "An asymmetric or hierarchical system in which the United States acted as banker for the world; the ultimate provider, along with military security, of a market for distress goods; a source of goods in short supply, and of capital requirements; a monitor of the system of international money including the pattern of exchange rates; and a lender of last resort in crisis—such a system may be possible to contemplate in economic terms. By the 1970s it was no longer in the cards politically."[42]

American commercial policy during the 1970s and 1980s was Janus-faced, diverging and not diverging from free trade. The institutions and policies erected after World War II to promote liberal trade have not been significantly altered. U.S. tariffs were at an all-time low of 2 percent-3 percent in 1987. But as E. E. Schattschneider wrote in 1935, "New policies create a new politics."[43] This dictum provides some insight into the partial disintegration of the free trade coalition in the 1970s and 1980s. As laissez faire trade ideology transformed from a heavily disputed intellectual ideal to an enshrined institution, new undercurrents of political activity among Republicans and, most noticeably, Democrats eroded the foundation of the liberal economic trade regime. The monolithic success of free-trade ideas provided many openings for policy defections in the ensuing years.[44] Specifically, the use of comparatively opaque trade measures, such as nontariff barriers (NTBs), allowed policy makers to restrict trade while pledging allegiance to the idea of unimpeded commerce.

41. Jacob Viner, "Economic Foreign Policy," *Foreign Affairs,* 39 (July 1961), p. 565.

42. Kindleberger, "U.S. Foreign Economic Policy," p. 413.

43. Schattschneider, *Politics, Pressures and the Tariff,* p. 288.

44. See John B. Judis, "The tariff party," *The New Republic,* March 30, 1992, pp. 23-25.

Richard Nixon's presidency witnessed the first dramatic turn away from liberal trade principles. Or did it? In the New Economic Plan of 1971 Nixon tried to invigorate the slumping American economy by suspending the convertibility of the dollar into gold and imposing a temporary 10 percent surcharge on imports. U.S. trade partners were stunned at America's lack of leadership during a time of general instability in the world economy. On the other hand, in 1973 Nixon helped initiate the Tokyo Round negotiations which reduced world tariff barriers to all-time lows.

Though Nixon sent mixed messages to Congress regarding his support of free trade, the liberalizing Trade Act of 1974 was passed during his administration. That act gave the president unprecedented authority to reduce, harmonize, or eliminate trade barriers. Pastor observed:

> "[O]ne can follow a distinct, consistent, and clear line from the 1934 Trade Act to its 1974 successor in the desire by the Congress for reducing barriers to trade, for empowering the President to negotiate first bilateral and then multilateral agreements, for permitting exemptions for those industries, firms, or workers which are severely injured by the impact of imports, and for gradually but determinedly increasing the powers of the Congress to oversee the administrative process to ensure that the law is executed equitably.... The nontariff, nonlegislative concessions to specific groups...are minor developments compared to the scope of multilateral trade negotiations."[45]

The United States-led postwar liberal trade regime has been surprisingly strong. The 1974 Trade Act continued America's affirmation of free trade, and the Tokyo Round attempted (with limited success) to address for the first time the issue of nontariff barriers. Further, the volume of world trade continued to increase at a respectable rate throughout the 1970s and early 1980s, even during recessionary periods for the most part.[46] In addition, though pressures for protection increased in the 1970s and 1980s, there were still many industries for whom access to new export markets was considered essential, including the insurance, banking, financial services, electronics, chemicals, pharmaceutical, agricultural, aerospace, biotechnology, and automobile sectors. Other multinational companies also recognized the importance of a liberal trading system.

Even Congress's post-World War II flirtations with protectionism seem to have had little effect. Though Congress is most susceptible to protectionist upwellings from affected constituencies, it has resisted legislating protective duties, a power it still retains even after the 1934 Trade Act. Congress did not give up power in that legislation, it merely granted new powers to the executive and removed itself as a focal point of social pressures and broadened responsibility for trade action. Judith Goldstein has argued that "[a]s more pressure is placed on Congress, it responds by expanding the powers of the bureaucracy, not by intervention."[47] For instance, Congress amended the escape clause criteria after 1974 to make it easier to gain relief. The result has in fact been higher acceptance rates for escape-clause cases. However, even though petition rates have increased for antidumping action, countervailing duties,

45. Pastor, *Congress and the Politics of U.S. Foreign Economic Policy*, p. 191.

46. Michael Michaely, "Trade in a Changed World Economy," *World Development*, 11/5 (1983), pp. 397-403.

47. Judith Goldstein, "Ideas, Institutions, and American Trade Policy," *International Organization*, 42 (Winter 1988), p. 192.

and relief under Section 337 (complex cases involving patent law or antitrust violation), acceptance rates have remained constant, an indication that the free trade consensus has held.[48]

In the years following World War II, Congress has often followed a loose practice of "cry and sigh" over protectionist legislation. Policy makers cry that they will enact restrictive trade policy and then they and the world sigh when little or nothing comes of it.[49] As Pastor noted, hundreds of quota bills were introduced in Congress in the 1960s, and in 1970, Wilbur Mills and 184 co-sponsors introduced a bill onto the House floor that called for voluntary export restraints on a number of consumer goods.[50] The protectionist bill failed, but the message to the president was clear. Members of Congress frequently sent strong messages to the president that their constituencies would not stand for excessive hardship brought on by increased import competition.

Like Nixon's tenure, the Reagan years also demonstrate a mixed record on trade policy. Considering Reagan's strong embrace of laissez-faire ideals, one would have expected important moves toward the further dismantling of trade barriers, at home and abroad. Indeed, the Uruguay Round of 1986 was initiated specifically at the request and urging of the U.S. administration. These negotiations were organized in 1982 when many U.S. domestic constituencies, suffering from a weak economy, were opposed to lowering trade barriers, a demonstration of Reagan's commitment to free trade. But it is also clear that the zeal that the president applied to his domestic policies was absent from foreign trade affairs. Most notable, Reagan engineered voluntary export restraints on Japanese autos in that same year.

In addition, Charles Pearson has warned of the entrenchment of the idea of "fair trade" as a basis for foreign economic policy during the Reagan years: "Until 1980 the proposition that the world was unfair and the United States fair remained an assertion; by 1988 it had been accepted as a fact beyond question among most policy makers and with the general public. More importantly it had become the cornerstone of U.S. trade policy...."[51] This was during a period when foreign trade barriers were not noticeably increased. Domestic pressures, not international economics, were clearly driving this pragmatic policy rationalization.

Unfair trade laws pose a potential danger to open U.S. markets because these laws appeal to Americans' sense of fair play. Antidumping and countervailing duties were little used in the 1960s, but in subsequent years both the legislature and the executive succumbed, to an extent, to growing cries for protection. Goldstein suggests that these laws can be overly restrictive because of the United States' liberal laissez-faire tradition: "The problem facing central decision makers, however, is that America's unfair trade laws hold an overly narrow interpretation of the legitimate relationship between producers

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48. Ibid., p. 205. See also Judith Goldstein, "The Impact of Ideas on Trade Policy: The Origins of U.S. Agricultural and Manufacturing Policies," *International Organization*, 43 (Winter 1989), pp. 31-71.

49. Pastor, *Congress and the Politics of U.S. Foreign Economic Policy*, p. 191-198.

50. Ibid., p. 134.

51. Charles S. Pearson, *Free Trade, Fair Trade? The Reagan Record* (Washington, D.C.: The Johns Hopkins Foreign Policy Institute, 1989), p. 73.

and the state."[52] She goes on to argue that the United States' standards for fair trade have been "overly ethnocentric": "States vary greatly in their philosophical and historical relationship to producers.... To use the U.S. case as a benchmark establishes criteria on the extreme end of a continuum."[53] Most European trading states historically fostered close government-producer relationships. Modern American policy makers and businesses, judging the world by the American standard, view this arrangement as an unfair advantage, a restraint on the free workings of the market.

In the end, these arguments only distract from the task at hand, that is, improving American competitiveness. The fair trade argument has a notable historical precedent, though not in this country. In the late nineteenth century, Britain's free trade policy "came under attack for failing to demand reciprocity from trade partners."[54] America's task is not to follow the British example.

Nontariff Barriers

In 1971, Bergsten warned about the growing prevalence of NTBs: "Nontariff distortions now probably rival tariffs as barriers to trade..."[55] NTBs arose to supersede tariffs as the dominant form of American protectionism in the 1970s and 1980s.[56] Nontariff barriers include "such traditional obstacles to trade as import quotas and unduly complicated customs procedures that tend to hinder international mobility of merchandise. They also include export subsidies, government procurement policies, and standards set for consumer or user protection."[57] NTBs first came to the attention of policy makers in the 1930s and 1940s, when some countries began replacing tariffs with import quotas and foreign exchange controls. Though the Kennedy Round brought about increasing recognition of the importance of reducing nontariff distortions, the focus of these negotiations was traditional tariff barriers. The Tokyo Round was the first organized attempt to reduce not only tariff but also nontariff barriers to trade.

These restraints of trade are more subtle than the old form (that is, tariffs) and may demonstrate, ironically, that the ideology of free trade has yet to be displaced from the political arena even though pressures for protection have increased. The lack of a coherent ideological alternative to laissez-faire trade theory is an important reason for the continuing openness of world markets.[58] The protectionism

52. Goldstein, "Ideas, Institutions, and American Trade Policy," p. 205.

53. Ibid., p. 199.

54. Pearson, *Free Trade, Fair Trade?* p. 15.

55. Bergsten, "The Crisis in U.S. Trade Policy," p. 626.

56. For an examination of specific American NTB's from 1974 to 1985, see Peter Morici, "Trends in U.S. Trade Policy and Non-Tariff Barriers," in John Whalley and Roderick Hill, eds., *Canada-United States Free Trade* (Toronto: University of Toronto Press, 1985), pp. 225-237.

57. Marks and Malmgren, "Negotiating Non-Tariff Distortions to Trade," p. 328.

58. Harry Shutt, *The Myth of Free Trade: Patterns of Protectionism since 1945* (Oxford: Basil Blackwell, 1985), p. 2.

of the 1970s and 1980s was ad hoc. These new barriers were more complicated and also less effective than the comprehensive tariffs of old because of countless loopholes and nonuniform application.

NTBs, however, present new challenges to the ideal of free trade and new problems for American policy makers. Olechowski and Sampson estimate that at least 21 percent of manufacturing imports by the United States were affected by NTBs in 1976.[59] Though U.S. tariffs were reduced from 29 percent in 1946 to only 4 percent by 1985, the combination of import tariff protection above GATT-negotiated levels, orderly marketing and voluntary export restraints, and quotas affecting merchandise imports rose from 8 percent to 22 percent in the period 1975-1985.[60]

NTBs have been used primarily as substitutes for tariffs, not as a new lever for previously unprotected industries. But they are perhaps more easily instituted because they do not require broad coalitions of support in Congress. Industries need not apply the threat of constituency backlash in order to gain protection from government agencies where political maneuvering need not be conducted in a public arena. Reflecting the "new politics" of the era, major economic and political actors eventually found access points as they adjusted to the new rules of the game. Jan Tumlir has noted that the constraints of decision making in a public arena are also absent from the executive branch, whose influence over trade policy has increased substantially since 1934.[61] The president was, in some ways, no more insulated from special interests than members of Congress. For instance, in response to increasingly loud cries from the American steel industry, the Nixon administration's prompting resulted in a 1969 voluntary export agreement by Japan and Europe to limit steel imports. And, as noted above, the grumblings of the U.S. auto industry resulted in a 1982 voluntary export agreement with the Japanese on autos.

Alternative Theories of Tariff Change

Considering the intriguing history of protectionism in the United States and elsewhere, it is not surprising that there is no shortage of general explanations for changing trade policies. The range of theories includes those that emphasize (1) the presence of a hegemon who ensures the openness of the trading system, (2) the importance of free trade ideology as a rationale for lowering trade barriers, (3) the effects of swings in the business cycle, (4) the function of public-sector institutions in shaping trade policy, and (5) the role of interest groups in garnering protection for sectors threatened by import competition.

59. Andrzej Olechowski and Gary Sampson, "Current Trade Restrictions in the EEC, the United States and Japan," *Journal of World Trade Law,* 14/3 (May-June 1980), Table 4.

60. Clyde H. Farnworth, "Trying to Shield Injured American Industries," *New York Times,* January 18, 1987, p. E5.

61. Jan Tumlir, *Protectionism. Trade Policy in Democratic Societies* (Washington, DC: American Enterprise Institute, 1985), pp. 15-16. For further critique of the institutional shift from legislative to executive authority over trade policy, see Charles Pearson and James Riedel, "United States Trade Policy: From Multilateralism to Bilateralism," in Enzo Grilli and Enrico Sassoon, eds., *The New Protectionist Wave* (New York: New York University Press, 1990), pp. 113-114.

Each of these theories has its virtues and failings, but together they paint a complex portrait of protectionist tendencies. From the broadest perspective, hegemony theory provides a description of the political and economic interaction among nation-states. Similarly, the influence of free trade principles can also explain international economic phenomena. On the national level, we get a view of the role of domestic business cycles. Adjusting the view yet again, public institutions and interest groups become the focus. Finally, though there has been little systematic literature in this vein, one could conceivably emphasize the role of individuals—a "great man" theory of trade policy. Consider, for example, the importance of Cordell Hull in promoting American leadership in the postwar liberal economic regime.

Hegemony

Hegemonic interpretations of trade policy hold that a single, overwhelmingly dominant economic power is necessary for the establishment and maintenance of a liberal trading regime.[62] According to this theory, only a single actor can create an open system, similar to the way that a national government provides a "public good" no private entity would be willing to supply, even though such a good might benefit not only that entity but also potentially the entire society.[63] Only this one hegemonic state can convince and/or cajole small and medium-sized states to maintain open markets. The hegemon acts to prevent "free riding" on the open trading system. In reality, some states will free ride, raising trade barriers to take advantage of other countries' (including the hegemon's) open markets. Only the hegemon will be sufficiently economically powerful to resist the temptation to react with similar barriers, a move that would damage the entire system.

The hegemonic model gained legitimacy because it seemed to fit the historical pattern of the nineteenth and twentieth centuries. Great Britain was the world's industrial powerhouse in the 1800s, and its clear moves toward trade liberalization pried open French and German markets, as well as those in the Commonwealth. As it unilaterally moved toward freer trade, most of the world followed. Similarly, in the next century, Britain was eclipsed by the United States in terms of economic output. Following World War II, U.S. dominance was critical in forging a liberal trade system after the disastrous tariff policies of the 1930s.

Under scrutiny, however, hegemony theory fails to explain a number of historical events and proves unable to provide a convincing rationale for state actions. John A. G. Conybeare presents a widely voiced criticism of the theory: "...[I]t should be noted that the association between openness and hegemony is weak on either time series or cross sectional evidence. Indices of hegemony and industrial country tariff averages over time correlate poorly, at least during the twentieth century, unless one

62. See Krasner, "State Power and the Structure of International Trade;" Charles P. Kindleberger, *The World in Depression, 1929-1939* (Berkeley: University of California Press, 1973); and Robert Keohane, *After Hegemony. Cooperation and Discord in the World Political Economy* (Princeton: Princeton University Press, 1984).

63. Robert Keohane has argued that a group of actors organized through an international regime can play a role similar to a single hegemon, a point which we will return to later in this paper.

postulates lags in the effect of hegemony on tariffs...."[64] Conybeare also argues that the examples of Great Britain in the nineteenth century and America in the twentieth as hegemonic leaders of liberal trade systems do not necessarily prove that free trade is the preferred economic choice of powerful states: "[T]here [is no] persuasive cross sectional evidence that strong powers prefer low tariff levels."[65] A strong argument can be made that the Cobden Chevalier Treaty between Britain and France in 1860 and the numerous trade initiatives of the United States in the post-World War II era were politically motivated national security moves.

The hegemony model is by no means perfect, but it provides important insights. First, though the time correlation is imperfect, one cannot ignore the fact that the two most economically powerful states of the nineteenth and twentieth centuries were instrumental in promoting worldwide free trade. Similarities such as this are too fundamental to dismiss as coincidence. It is possible that a future hegemon might not be committed to liberal trade, but it would also be extremely difficult for a nation that lacks dominance in economic might to create and sustain a liberal trading regime, if that nation wished to do so. Second, Conybeare argues that hegemons do not necessarily have an *economic* interest in open markets. This may in fact be the case, yet it merely reveals another compelling dimension of the hegemonic thesis. Throughout history, powerful economic states have often demonstrated a strong interest in international political affairs; it is not surprising that these states have often been political and military powers as well. The hegemons that arose after the development of free trade theory (Britain and the United States) have thus tended to promoted free trade as the most logical peaceful means to cement economic and political ties with other states. Formal diplomacy is another way to achieve a similar end, but diplomacy alone offers fewer rewards than a mutually beneficial trading relationship.

Ideology

It has long been argued that free trade ideology was the motivating factor behind worldwide trade liberalization. Ideology, however, is one of the bluntest theoretical tools for analyzing changes in national trade policy. Beginning in the late eighteenth century, Ricardo and a host of other economists developed a massive body of literature on the benefits of free and open trade and eventually generated a nearly invincible set of theoretical propositions. However, political actors have historically not heeded economic wisdom unless it was congruent with political expediency. The question is, how can one determine whether economic theory was the motive behind liberalization or merely an incidental factor compared to other political or social determinants? Ideology is clearly an important variable, but it does not fit neatly into any testable model.

The British experience most strongly supports an ideological explanation of trade policy change. Guilio Gallarotti has noted, "From the 1820s on, after free-trade ideology became an influential force in political circles, tariff changes exhibit an unbroken liberal trend. All twelve changes [in tariff levels]

64. John A.G. Conybeare, "Public Goods, Prisoner's Dilemmas and the International Political Economy," *International Studies Quarterly,* 28 (1984), p. 12.

65. Ibid.

between 1820 and 1879 are reductions."[66] The experience of the United States, however, does not bear out an ideological interpretation of trade policy. Obviously, different countries require different explanations for their embrace or rejection of liberal trade. The U.S. does not fit the ideological model because economic theory played a relatively small part in early American trade policy, and other factors were more important in the transition to a liberal orientation. However, the theoretical consensus on the advantages of free trade has been important in the maintenance of an open domestic market.

Students of trade policy often conceive of "ideology" simply as the mass of economic theories that support the idea of free trade. However, ideology can also be a dimension of a particular nation's political culture. Understood in this way, ideology provides new insights into domestic protectionist sentiments. In what ways has American trade policy been related to American culture? How do different elements of the American ideology interact to support or reject protectionism? These and other questions indicate the usefulness of ideology theory, broadly defined.

Business Cycle

The relationship between national economic health and tariff levels was explored as early as 1879 by Gustav Schmoller, an economist of the German historical school: "The times of boom, of increasing exports, of new openings of overseas markets, are the natural free trade epochs, while the reverse is true in times of foreign slumps, of depressions, of crisis."[67] The predictive accuracy of the business cycle model is superior to the hegemony and conventional ideology theories, though it is most useful in predicting tariff changes in periods of extreme expansion or contraction.[68] Gallarotti, among others, has convincingly demonstrated the value of the business cycle theory as a "scientific" tool.

However, this tool's failings are numerous. First, predictions that we would expect from the business cycle theory have not reflected the reality of changes in the trading system over the past two decades. In 1983, Michael Michaely argued that the downward adjustment of the long-term business cycle beginning in 1973 brought no structural changes in the international economic regime and witnessed the continuing growth of trade among nations.[69] Indeed, Gallarotti grants that American business cycle theory does best in the period before the Civil War.[70] On this basis, we question its relevance for modern students of U.S. trade policy.

More important, the business cycle model fails to provide a reasonable explanation of the actual forces and actors that generate tariff changes. The theory describes policy outcomes instead of policy

66. Guilio Gallarotti, "Toward a Business-Cycle Model of Tariffs," *International Organization,* 39 (Winter 1985), p. 179.

67. Quoted in Timothy J. McKeown, "Firms and Tariff Regime Change. Explaining the Demand for Protection," *World Politics,* 36 (January 1984), p. 215.

68. Gallarotti, "Toward a Business-Cycle Model of Tariffs," p. 171.

69. Michaely, "Trade in a Changed World Economy," pp. 397-403.

70. Gallarotti, "Toward a Business-Cycle Model of Tariffs," pp. 183-184.

sources and development. In particular, the problem with using the business cycle to explain American tariff policy is that the purposes of the tariff have changed in significant ways throughout the country's history. For instance, it is unclear whether nineteenth-century recessions generated calls for higher tariffs because of increased pressure from threatened sectors of the economy, or because of the fiscal needs of the federal government. The need for revenue was a political argument frequently used in support of upward tariff adjustments, such as during the Civil War in 1861. Tariffs accounted for more than 90 percent of federal government revenues in the early decades of the republic and were still approximately 40 percent to 50 percent before Wilson signed into law the reductions of the Underwood-Simmons Act of 1913.[71] Conversely, budget surpluses brought calls to lower the tariff, such as during the 1857, 1861, 1875, 1883, and 1890 debates of tariff acts. Though the business cycle theory might be validated in either case, it provides a false sense of continuity and belies the varying complexity of the elements that influenced tariff changes.

Interest Groups

E. E. Schattschneider's *Politics, Pressures and the Tariff* was the first systematic analysis of the effect of special-interest pressure on United States trade policy. Schattschneider explained how the 1930 Smoot Hawley Tariff was produced by the influence of small, well-organized, import-competing producer groups—industrial and agricultural—which overwhelmed the larger public interest (that is, freer trade).

Interest groups are motivated to restrict foreign trade by the economic and social instability that freer trade may cause. Although open markets may be the optimum economic alternative in the aggregate, specific sectors of an economy may suffer under freer trade as comparative advantage begins to put pressure on less-efficient industries. "Social instability is thereby increased since there is friction in moving factors, particularly labor, from one sector to another."[72] The high costs of adjustment generate the organization of threatened factors into interest groups.

A simple interest group model portrays the government as neutral arbiter between competing groups. "[T]he more competitive the political system, the more likely distribution questions will dominate efficiency considerations on special-interest issues.... [P]oliticians are similar to auctioneers calling out prices in an organized commodity market: they try different prices until the purchase orders equal the sell orders."[73] Tariff policy can thus be seen as "rent-seeking" behavior by well-organized producer groups and loosely organized consumer groups. This latter category can be widened to include export-oriented industries.[74]

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71. William J. Gill, *Trade Wars Against America: A History of United States Trade and Monetary Policy* (New York: Praeger, 1990), p. 6.

72. Krasner, "State Power and the Structure of International Trade," p. 319.

73. William A Brock and Stephen P. Magee, "Tariff Formation in a Democracy," in John Black and Brian Hindley, eds., *Current Issues in Commercial Policy and Diplomacy* (New York: St. Martin's Press, 1980), p. 1-2.

74. The famous Stolper-Samuelson (1941) model suggests this categorization by arguing that in a two-factor economy the abundant factor will favor free trade and the scarce factor, protection.

There is a large body of literature that attempts to explain which groups receive protection. Through group theory modeling matched to historical evidence from the Tariff Act of 1824, Pincus asserted that "the ideal industry pressure groups in 1824 had low proprietal income shares and geographically concentrated production units, but that political effectiveness required the group to speak for many establishments with output spread fairly evenly across states."[75] Réal P. Lavergne's study of pressure group influence indicated that industries that employ large work forces and are geographically concentrated in large states were more likely to receive higher levels of tariff protection.[76] While Goldstein found that industries that are export oriented, spent relatively less on capital investment, and petitioned for relief less often were more likely to gain aid.[77] Though there is some overlap among these groupings, the success of different interest groups in lobbying for protection obviously varies from case to case.

The success or failure of a group in petitioning for protection from imports is also influenced by the extent to which particular sectors are identified with Americanism, the national culture. For instance, agriculture, as in many European countries, is closely associated in the national mind with the American way of life—property ownership, self-sufficiency, and a rural lifestyle characterized by morality and virtue. Similarly, the auto industry is seen as a distinctly American symbol of independence and the pioneering spirit.[78]

Today, organized labor is thought to be among the most powerful and vocal opponents of free trade. But from the passage of the 1934 Reciprocal Trade Agreements Act to the Trade Expansion Act of 1962, organized labor was strongly committed to free trade.[79] Labor realized that increased exports could produce significant gains for its members. However, with increased competition in the domestic market from imports and the prospect of plant relocations to countries with cheaper labor, unions began to shift toward protectionism in the late 1960s. The highly restrictive Burke-Hartke bill of 1971 received strong support from labor.

Interest group theory is subject to a number of criticisms. Most important, it is an exaggeration to say that special interests set national trade policies. There are simply too many examples of threatened industries that petition for protection but do not receive relief. Indeed, Lavergne's overall study of six variables ultimately showed the pressure-group variable to be one of the weakest correlates to the

75. J.J. Pincus, "Pressure Groups and the Pattern of Tariffs," *Journal of Political Economy,* 83 (August 1975), p. 757.

76. Réal P. Lavergne, *The Political Economy of U.S. Tariffs* (New York: Academic Press, 1983), p. 92-106.

77. Goldstein, "Ideas, Institutions, and American Trade Policy," p. 208.

78. Enrico Sassoon, "Protectionism and International Trade Negotiations," in Enzo Grilli and Enrico Sassoon, eds., *The New Protectionist Wave* (New York: New York University Press, 1990), p. 10.

79. For a history of organized labor's limited pre-1930 impact on U.S. trade policy, see Margaret Hardy, *The Influence of Organized Labor on the Foreign Policy of the United States* (Ph.D. Dissertation, The University of Geneva, 1936), pp. 195-205.

application of protectionist measures.[80] Second, the model has difficulty accounting for policy changes over time. Since the level of protection of an economy changes, the impact of interest groups must not be constant over time. Only if we wed the interest group theory to the business cycle (thus arguing that in recessionary periods, group activity increases and causes the establishment of higher trade barriers) can policy be explained by the role of interest groups. Finally, the model is, in some senses, tautological. It explains protectionism by analyzing the special interests that receive relief and then interprets the lobbying of these groups as evidence that the groups themselves were instrumental in the increased protectionism.

Institutions

Judith Goldstein, among many others, casts doubt on oversimplistic interest group theories of protectionism by emphasizing the importance of the structure and norms of public institutions. "Although in the long term groups may be able to organize and change the general character of American institutions, in the short term laws and norms have significant impact on their ability to translate social action into public goods."[81]

Models of tariff change in democratic societies often hold to the intuitive premise that government institutions will reflect the will of the people. "The preferences of government officials are usually linked to the pattern of preferences in their societies, simply because in systems with some form of representational mechanisms, the occupants of governmental posts will change along with changes in the pattern of opinions and demands."[82] However, this assumes that decision-making power lies with elected officials, a not entirely accurate picture of the way trade policy is created and implemented. Executive and legislative agencies have a significant role in adjudicating trade grievances and implementing trade laws, often with wide discretion to interpret the laws. And these institutions often have a long life. "In the U.S., a society embalmed in the 'rule of law,' legal constraints encourage the layering, rather than the replacing of government institutions."[83] Ideas that are embedded in institutions can affect policy through time, regardless of the current beliefs and constraints of policy makers.

The institutional model of tariff change presents one of the most serious criticisms of interest group theory. Interest group models, in their most basic form, assume that the actors and the organizational structures of the political arena are the same as, or at least analogous to, the marketplace. In some cases the analogy holds, but in politics it is not only circumstances that change but also the rules of interaction themselves, sometimes incrementally, sometimes dramatically. As Lavergne notes, "...the success that special interests can be expected to have in securing privileges is not constant in any sense,

80. Lavergne, *The Political Economy of U.S. Tariffs*, pp. 183-187. The other variables, in addition to pressure-group influence, were the minimization of displacement costs, the comparative disadvantage of the industry, international bargaining, maintenance of historical continuity, and miscellaneous aspects of the public interest.

81. Goldstein, "Ideas, Institutions, and American Trade Policy," p. 186.

82. McKeown, "Firms and Tariff Regime Change," p. 216.

83. Goldstein, "Ideas, Institutions, and American Trade Policy," p. 181.

but rather depends on the rules of the game as determined and constantly revised by the politicians themselves."[84]

Institutional reforms have been crucial in the transformation of United States trade policy in the twentieth century. When Congress delegated reciprocal tariff adjustment authority to the executive in 1934, it dramatically altered the way the trade game was played nd effectively reduced the importance of interest groups in setting national trade policy.[85] This new executive power over international trade was a major factor in the gradual shift to liberalization. Michael Borrus and Goldstein note that "even where well-organized opposition to open trade exists, the norms that have developed and the institutions which have been created to implement the United States trade policy do not necessarily respond to the opposition.... [I]nterest group pressures to change established policy may be ignored."[86]

America's waning hegemony in the 1960s and 1970s brought with it, for reasons unrelated to the country's growing competitiveness problems, Congressional reforms that made the legislature more susceptible to protectionist pressures. "Since the mid-1970s, procedural reform in both the House and Senate has eroded the power of committee chairmen to control the pace and content of legislation. In the House, power has devolved on a host of specialized subcommittees and on the party leadership. The Senate has also imposed a degree of accountability on its chairmen and permitted a greater degree of independence for its junior members."[87] These democratizing reforms increased decentralization in the Congress and loosened already undisciplined party organizations. In the past, the leadership of key party members had been vital in forging a free trade consensus over the parochial interests of individual policy makers. The consensus has deteriorated in part because of these institutional changes.

However, by some measures Congress did not encroach upon the executive's power in the 1970s and 1980s, as in the case of the application of the escape clause rule: "Institutionalization of the president...as the final enforcer of the escape clause trade remedy assured that free trade policy could triumph even where objective statutory criteria for protection were met."[88] Since outright tariffs were not on the political table, Congress often provided relief to threatened industries through the application of NTBs. Congress responded to protectionist pressures not by raising tariffs but by loosening the criteria by which an industry can seek relief and by increasing the powers of independent legislative agencies that oversee trade issues.[89]

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84. Lavergne, *The Political Economy of U.S. Tariffs*, p. 31.

85. Lavergne argues that two other factors were also important: (1) adaptations of the rules of process in the Congress itself and (2) the switch from a unilateral approach to trade policy changes to a negotiated approach.

86. Michael Borrus and Judith Goldstein, "United States Trade Protectionism: Institutions, Norms, and Practices," *Northwestern Journal of International Law & Business*, 8 (Fall 1987), pp. 333-334.

87. Raymond J. Ahearn, "Political Determinants of U.S. Trade Policy," *Orbis*, 26 (Summer 1982), p. 421. These reforms were largely the result of Watergate; they sought to reduce the importance of seniority and patronage in Congress.

88. Borrus and Goldstein, "United States Trade Protectionism," p. 341.

89. For a specific example of institutional change affecting trade policy in the post-World War II era, see Lavergne, *The Political Economy of U.S. Tariffs*, p. 29.

The American political system makes it difficult to achieve swift institutional transformation without a radical mandate for change. The separation of powers limits the ability of any one body or branch to affect reforms of the sort that would immediately shift institutional perspectives. In the case of trade policy in the 1930s, "Congress delegated power to the executive branch to set tariffs, partly to protect the economy from the ill effect log-rolled tariffs."[90] With this original mandate in mind, many trade institutions viewed their mission as restraining the legislature's tendency to make trade policy that does not make good economic sense. This mission retains its vitality because of the virtually universal acceptance that, in a perfect world, trade would be free and open. The dominance of free trade ideology provides these institutions with a strong mandate to resist protectionism.

It is clear that the nature of the American political system makes the institutional theory of protectionism an important tool in analyzing trade policy. In fact, Lavergne's tariff study notes that historical continuity is one of the most important determinants of tariff levels, indicating the persistent influence of old institutions and the political culture which underlies those institutions.[91]

The American Creed and Protectionism

The history and importance of the American Creed has been well documented by Louis Hartz, Samuel Huntington, Lipset, and many others.[92] Its tenets include anti-statism, individualism, populism, and egalitarianism. These elements portray a rich national character but one that lacks a driving concern about relations with the rest of the world. For their first century as a nation, the only border that Americans concerned themselves with was their own western frontier. Mexico and Canada have been a mystery to most U.S. citizens, who rarely pay attention to the affairs of their neighbors to the north and south. Thus, from one perspective the American Creed is an inward-looking ideology. Possessed of abundant natural wealth and a talented population, geographically isolated from the powerful nations of the world, and militarily secure in its hemisphere, America grew up as an only child.

And the behavior of the United States in the international arena has sometimes reflected poor social skills. Nineteenth- and, to some extent, twentieth-century American foreign policy initiatives have often been characterized as amateurish. This is understandable for a society with the United States' ideological history. The founding fathers and subsequent generations were immersed in a debate over what kind of a republic America should be: the agricultural society along Jefferson's lines or the manufacturing power envisioned by Hamilton. Both of these factions strove for the end goal of national economic self-sufficiency, and they were both inward-looking. As Theodore Lowi and Benjamin Ginsberg put it, "...during most of the nineteenth century, American foreign policy was to a large extent no foreign policy."[93]

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90. Borrus and Goldstein, "United States Trade Protectionism," p. 334.

91. Lavergne, *The Political Economy of U.S. Tariffs*, pp. 164-166.

92. See Hartz, *The Liberal Tradition in America*, Seymour Martin Lipset, *The First New Nation. The United States in Historical and Comparative Perspective* (New York: Norton, 1979 reprint), and Samuel Huntington, *American Politics. The Promise of Disharmony* (Cambridge, M.A.: Harvard University Press, 1981).

93. Theodore Lowi and Benjamin Ginsberg, *American Government* (New York: Norton, 1992), p. 756.

Early political analyses by Washington and others demonstrated an allergic response to European politics and "entangling alliances." Throughout this period and into the twentieth century, artful diplomacy was considered a suspiciously "European" pursuit. It smacked of secret treaties, shifting and opportunistic alliances, and unelected bureaucrats making policy without the mandate of the people. The image of diplomacy as an aristocratic game offended the strongly populist and egalitarian cultural roots of Americans. In fact, it was not until the Foreign Service Act of 1946 that a professional diplomatic corps was finally established in the United States.

The result of this history was a foreign policy—economic and political—that could be described as unilateral, isolationist, or sometimes both. In the case of U.S. tariffs, barriers were kept high partly to ensure economic independence and partly as a source of revenue. While this policy denotes isolationism in its closure of the domestic market, it was implemented without concern for how other nations would respond, an indication that unilateralism was a guiding principle as well. U.S. actions in the international arena have been profoundly influenced by the values of the American Creed.

The Creed, however, rationalized two seemingly polar opposite perspectives on America's role in the world. We have said that the first perspective dominated through the 1900s, but a second arose to coexist with the first. This ideological shift in the political culture was that of an inward-looking perspective somehow transformed into idealistic internationalism.

In the late nineteenth century economic considerations led American producers and policy makers to recognize the value of foreign relations, or more specifically, foreign markets. But economic considerations were clearly not a sufficient impetus for liberalization; if they had been, then the dismantling of trade barriers would have begun at least by the turn of the century. There is little doubt that a more open trade policy would have been in the national interest in the 1920s, but the social structures and institutional arrangements that protected import-competing industries in the last century were effectively stronger than the state. Equally or more crucial were societal responses to events such as the worldwide strangulation of trade after Smoot-Hawley, the vulnerability induced by the attack on Pearl Harbor, and the dawning of the nuclear age. In technical terms, "the condition of the environment required to drive the system to the collusive solution is much higher than the level required to maintain it once it has achieved this position...."[94] Krasner notes that the potato famine of the 1840s was a critical impetus for the repeal of the Corn Laws and Britain's gradual move toward free trade. Similarly, "the United States did not assume the mantle of world leadership until the world had been laid bare by six years of total war. Some catalytic external event seems necessary to move states to dramatic policy initiatives in line with state interests."[95] Consider that the Reciprocal Trade Agreement Act of 1934 was passed only after the world was deep in depression *and* there was a fairly wide consensus that the radically higher barriers of the Smoot-Hawley Tariff played a role in worsening the nation's economic plight.

Like the turning of a kaleidoscope which produces many images with a finite number of crystalline forms, events such as the Great Depression and World War II helped to "rotate" the "form" of the American Creed, producing internationalism as an ideological counterpart to the tradition of

94. William Williamson, "A Dynamic Model of Inter-Firm Behavior," *Quarterly Journal of Economics*, 79 (November 1965), p. 583.

95. Krasner, "State Power and the Structure of International Trade," p. 341.

isolationism and unilateralism. Ironically, in spite of its dichotomous relation to that tradition, internationalism was just as much a product of the national ideology and meshed easily with the tenets of the creed. Indeed, this new outward-looking perspective achieved legitimacy by allying itself with, and in effect sewing itself into the fabric of, American political culture.

Internationalism brought American ideals out of the exceptional context of the United States and onto the world stage. In this new arena, ideals such as liberty were broadened to include unrestricted commerce not only within but also between countries. Ben Wattenberg has called the United States the first "universal nation," and indeed this is how Americans have conceived of their creed—a set of values imbued with universal truth and ready for export.

Again, this shift was possible only because elements of the creed legitimized the new internationalist perspective. One of the most important of these elements was America's history of religious sectarianism. The emphasis on Americanism as a political ideology has led to a utopian orientation among American liberals and conservatives. Both seek to extend the "good society." But the religious traditions of Protestant "dissent" have called on Americans to be moralistic, to follow their conscience with an unequivocal emphasis not to be found in countries whose predominant denominations have evolved from state churches. The dissenters are "the original source both of the close intermingling of religion and politics that [has] characterized subsequent American history and of the moral passion that has powered the engines of political change in America."[96] As Robert Bellah has emphasized, "[t]he millennialism of the American Protestant tradition again and again spawned movements for social change and social reform."[97] The American Protestant religious ethos has assumed, in practice if not in theology, the perfectibility of humanity and an obligation to avoid sin, while the churches whose followers have predominated in Europe, Canada, and Australia have accepted the inherent weakness of people, their inability to escape sinning and error, and the need for the church to be forgiving and protecting.[98]

Americans are utopian moralists who press hard to institutionalize virtue, to destroy evil people and eliminate wicked institutions and practices. They tend to view social and political dramas as morality plays, as battles between God and the Devil, so that compromise is virtually unthinkable. This is, of course, part of what some people see as problematic about American foreign policy.[99] As Samuel Huntington has noted, Americans give to their nation and its creed "many of the attributes and functions of a church...."[100] These are reflected, as Bellah has stressed, in the American "civic religion," which

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96. Huntington, *American Politics: The Promise of Disharmony,* p. 154. For documentation, see pp. 8, 31-2, 84-104.

97. Robert Bellah, *The Broken Covenant: American Civil Religion in Time of Trial* (New York: Seabury Press, 1975), p. 48. See also Sacvan Bercovitch, *The American Jeremiad* (Madison: University of Wisconsin Press, 1978), pp. 20, 94.

98. Lipset, *The First New Nation,* pp. 166-169.

99. George Kennan, *Realities of American Foreign Policy* (New York: Norton, 1966), pp. 3-50; Robert Bellah, *Beyond Belief* (New York: Harper and Row, 1970), pp. 182-183.

100. Huntington, *American Politics,* pp. 158-159.

has provided "a religious dimension for the whole fabric of American life, including the political sphere." The United States is seen as the new Israel. "Europe is Egypt; America the promised land. God has led his people to establish a new sort of social order *that shall be a light unto all nations.*"[101] Everett Carll Ladd adds, "[t]o understand the American ideology, we need to see individualism not as a dimension of individual character but rather as a *moral* standard by which social institutions and practices are judged."[102]

This moral standard presses policy makers to promote Americanism throughout the world. The ideals of freedom, liberty, and equality are seen as gospel, truths appropriate for all nations. Similarly, the American system of commerce also must be spread to societies seeking economic growth. Exporting the idea of free markets, of course, requires that the U.S. lead the way in unrestricted trade, a demand which was made of America only after World War II. Ideological consistency could no longer be sacrificed to the protectionist constituencies of members of Congress eager to please. The American Creed had taken center stage in the international arena.

This is not to say that there was an immediate shift to internationalism. It is important to remember that both foreign policy perspectives—isolationism-unilateralism and internationalism—are justified by the same creed. These two perspectives coexisted up until the Second World War. However, the terrible impact of Smoot-Hawley and then Pearl Harbor erased any notions of American separateness from world affairs. The only child was getting a crash course in socialization. Corresponding to this shift, the tariff debate became framed in the context of international commitments rather than national concerns. The rules of the trade game changed irrevocably when the U.S. was thrust into the international arena as the leading economic and military power. "With its ascendancy to a position of leadership in international affairs, the American executive eventually succeeded in redefining the question politically in viewing the tariff as an instrument of management of the international system."[103]

The internationalist view predominated up until the 1970s and the Vietnam War, another culturally wrenching event in American history, but isolationist-unilateral tendencies were never very far beneath the surface because the American ideology continues to legitimize them. To a large extent, the task is to keep the society—its public and its policy makers—looking outward, tapping the elements of the creed that generate political and economic openness rather than protectionism. Paul Gottfried has noted that this task is made easier by the facts of the modern era: "In an age of international economies,global communications, and contaminating atomic power and galactic weapon systems, it is no longer possible not to exert political influence on other parts of the world."[104] But the temptation to turn inward still exists for Americans, ironically because of the continuing vitality of the creed.

101. Bellah, *Beyond Belief,* p. 175 (emphasis SML); Kenneth D. Wald, *Religion and Politics in the United States* (New York: St. Martin's Press, 1987), pp. 48-55.

102. Everett Carll Ladd, "The American Ideology. An Explanation of the Origins, Meaning, and Role of 'American Values,'" (Storrs, CT: unpublished paper, February 1992), p. 7 (emphasis SML).

103. Ibid., p. 28.

104. Paul Gottfried, "Sovereign State at Bay," *Society,* 29/6 (September/October 1992), p. 22.

One of the most interesting questions is why U.S. leadership of the post-World War II liberal trade regime weakened after such a short time. The British carried the free trade mantle for more than 80 years, while the U.S. commitment began to lag after only about 30 years. America the classically liberal, laissez faire, bourgeois state has proved—counterintuitively—to be a less than ideal hegemonic leader of a liberal international economic system.

American leadership was tenuous partially because the American system of government reflects the national political culture. It is a truism that, given identical circumstances, nations will react in very different ways: "international structure can remain the basic determinant of the national interest. States do, however, vary in their ability to act on these interests."[105] Similarly, states differ in their ability to react to domestic factors. A more powerful central government is, theoretically, better able to resist the temptations of short-term, direct intervention through trade policy. A strong society and a weak state make America a dubious trade leader. Peter Katzenstein is certainly not the first to argue, "[i]n America the public interest was served not be a concentration of power in strong state institutions but by a dispersion of power among many weak ones...."[106] Thus, "society-centered networks in the United States give free play to the quest for economic aims," i.e. protectionism.[107] In this case, the antistatist creed played a role in increasing government interference in trade.

The populist element of the American Creed also contributed to the continuing vitality of inward-looking trade politics. The popularity of protectionist measures among the general public can be viewed as a corollary to the powerful democratic orientation of the society. The political system has been historically responsive to the voice of the people, which in this case has supported the protection of U.S. workers and industries. Public opinion data bears out the long-term romance of the American public and restrictive trade barriers. Economist James Tobin posed the question only implicitly articulated by Americans, "why the preferences of individuals 'should be worthy of respect only when they are expressed in the market, why the preferences of the very same individuals expressed politically should be regarded as distortions.'"[108]

The kaleidoscopic American Creed continues to shift and thus legitimate, on the one hand, a zealous and often idealistic internationalism, and on the other an inward-looking concern. The question is, what image will the Clinton administration derive from this societal kaleidoscope, and what will the future hold for free and open trade? All the available indicators suggest that it will continue to be used to endorse predemocratic activist policies and free trade.

105. Goldstein, "Ideas, Institutions, and American Trade Policy," p. 185.

106. Peter J. Katzenstein, "International relations and domestic structures: foreign economic policies of advanced industrial states," *International Organization,* 30 (Winter 1976), p. 15. See also Samuel Huntington, "Paradigms of American politics: beyond the one, the two and the many," *Political Science Quarterly,* 89 (March 1974), pp. 1-26.

107. Ibid., p. 21.

108. Quoted in Goran Ohlin, "Trade in a Non-Laissez-Faire World," in Paul A. Samuelson, ed., *International Economic Relations* (New York: St. Martin's Press, 1969), p. 174.

Conclusion

The world does not possess the characteristics that would make open world trade the likely result of multilateral negotiations. America, still the wealthiest and most productive nation in the world, is no longer the economic giant, towering over its nearest competitors. Nor does it seem likely, barring catastrophe or war, that the economic balance of power will shift so dramatically as to create another such hegemon in the near future. Because of the many powerful economic and welfare policy tools of the modern liberal state, the national rise or decline of any of these countries is likely to be gradual. The balance of economic power will thus not shift dramatically in the medium term. The U.S., Japan, and Germany (the European Community) now represent a powerful triumvirate, without a clear leader. The emerging NICs and/or China might join the ranks of this group in the coming years, but no single country possesses the economic *and* political power to act as a leader and policeman of a liberal trading regime. In describing the prospects for the international system, Arthur Cyr notes:

> Germany and Japan represent rising powers on the international stage, with consequent political impact and influence, yet both operate almost purely in the realm of economics. Even while competing effectively with the United States, they are closely linked with and largely defer to us in military security terms. The United States controls a declining share of the gross product of the world, yet remains an enormously important and diverse economy and, as the Persian Gulf War has demonstrated, retains a formidable capacity to deliver military destruction over long distances.[109]

Britain was unique in the nineteenth century as the shining example of industrial and imperial success, and America was exceptional after World War II as supplier to the world of both material goods and an inspiring ideology of freedom and equality. Realistically, no country, except perhaps the U.S., will be able to assume such a place in the international arena in the next few decades, and such an outcome is extremely doubtful.

Historical wisdom is that a multipolar balance of power makes the ideal of world free trade just that: an ideal. In the past this situation would be a cause to fear that protectionism was around the corner. Yet, as we have seen, world trade volume continues to grow, and governments have not abandoned free trade to protect domestic markets. The American Creed continues to legitimize the ideological consensus in this country. However, this is not a reason to continue down the path of ineffective multilateral negotiation and reject bilateral free trade initiatives.

Bilateralism represents the best hope for eventual free and open trade throughout the world. First and most important, successful bilateral agreements solidify the free trade ideological consensus. As Goldstein notes, "nothing establishes the legitimacy of a policy like success. Policies become institutionalized because they work."[110] Second, bilateral trading blocs present the first opportunity in modern history to develop and sustain a liberal international economic regime without the presence of a hegemon. Robert Keohane argues that groups of nations might be able to act as a collective hegemon, yet there are serious collective action problems inherent in such an arrangement. On the other hand, bilaterally produced free trade blocs such as NAFTA could potentially act as a single unit with a generally

109. Arthur Cyr, "Neo versus New Isolationism," *Society*, 29/6 (September/October 1992), p. 21.

110. Goldstein, "The Impact of Ideas on Trade Policy," p. 71.

unified set of interests in negotiating with other nations or other free trade blocs. The collective action problems inherent in this type of arrangement are considerably less problematic than in a multilateral negotiating system. Of course, this scenario assumes continued interest in multilateral free trade by the blocs, but so does any scenario of individual nations acting to liberalize trade. Thus, we can conceive of the prospect for a stable liberal system without a hegemon, something not experienced in either the nineteenth or the twentieth centuries.