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North-South Trade Relations in the Americas: The Case for Free Trade

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

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Free trade in the Western Hemisphere is in the common interest of all participants. With benefits to be reaped by 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 us well in the postwar period, especially in the North Atlantic trade relations. It can yield extra benefits in the ambitious targets set in the Uruguay Round liberalization 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 faces 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 block in the 1990s. Turning our back 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 wage levels, back to their 1980 level and beyond. By contrast, trade restriction here must mean even more poverty there; and with more poverty there will be fewer rights and a greater risk of political radicalism, neither of which is in the American interest.

REGIONAL TRADE ARRANGEMENTS AND GATT

Concerns about pursuing a regional trade liberalization stem to some extent from fears about the dynamics of the world trade game.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 blocks? 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

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

emphasized that four fifth of world trade is taking place within trading blocks: intra-region trade in the EC, EFTA, and the US-Canadian free trade agreement already account for 61 percent of world trade and various other groups make up the balance. Indeed, if world trade has seen such an expansion in the postwar period, it is because regional arrangements facilitated the acceptance of otherwise difficult trade opening?

The opposition to plurilateral approaches is more than anything a 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 that it helped create in the 1930s. The multilateral system has served us well and still does, but it certainly does not represent a unique and exclusively track toward freer trade.

The policy debate in the United States has been until quite recently 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 and the liberal trading system is eroding. Moreover, trade policy initiatives in Europe and in Asia, are working quite possibly to the detriment of US-located production. In such an environment a search for more effective U.S. trade policy assumes special importance. To reap the real income gains that freer trade can offer the United States must not be blocked by limiting negotiations to a potentially unproductive GATT process.

Moreover, if the system is open in the sense of allowing conditional MFN access, a bilateral initiative can become a vehicle for freer trade on a regional basis. Regional initiatives are a policy option that pushes the world economy toward freer trade, complementing the GATT process 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, GATT notwithstanding, Europe has used regional approaches over and over again, from the European Payments Union to the Common Market and EFTA, and to 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 and Portugal, North Africa and Turkey. Developments in Eastern Europe offer the prospect that this region will soon enjoy a preferred trade status with the Common Market just as all of EFTA already does.

The major regional effort in which Europe is involved removes any conceivable argument that a U.S. free trade block policy would undermine an otherwise intact multilateral system. The Europe 92 project so clearly foreshadows trade discrimination that the EFTA partners are scrambling to get inside the deal 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 to the extent of 70 percent intra-European trade, there is very little else. Nobody would argue that the rapid growth of intra-European trade is the outcome of a destructive inward looking strategy. On the contrary, it is giving energetic support to the idea of trade liberalization. In fact, regionalism is the best idea in free trade thinking for a long time.

A SNAPSHOT OF THE AMERICAS

Before developing arguments in support of regional free trade, here is a brief view of what the region looks like in terms of macroeconomic indicators.²

Table 1 Comparative Data: 1991

	Population (Mill.)	GDP (Bill \$US)	GDP Per Capita (\$US)	Compensation (\$US/hour)
U.S.	253	5,678	22,443	15.45
Canada	27	574	21,259	17.31
W.Hemisphere ^a	450	1,000	2,222	
Brazil	153	418	2,732	2.55
Mexico	88	248	2,818	2.17

^aestimate

Source: World Bank, U.S. Dept. of Labor and national sources.

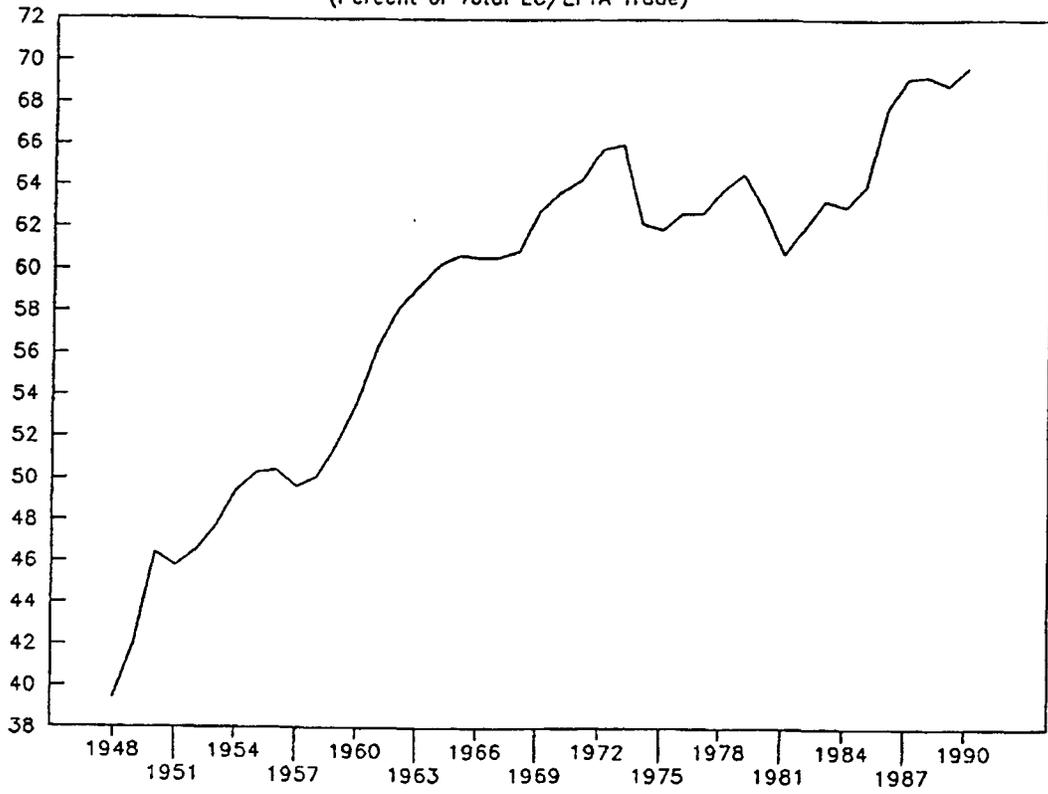
The very first impression is the totally disproportionate weight of the U.S. Even using the World Bank's ICP measures of per capita income, the discrepancy between North and South is still a factor of 4.³ Next,

²The year 1989 is used since is the most recent year with complete GDP data for every country in the region.

³Using 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.

INTRA-EC/EFTA TRADE

(Percent of Total EC/EFTA Trade)



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-i-Martin (1991) have studied the pace of convergence among regions. Their conclusion is that the per capita GDP gap between two 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 to have in mind since it establishes that the regions are starkly unequal in their incomes, as far as the eye can see and beyond.

The other point to address is the state of trade integration today. Looking only at merchandise, Table 2 gives some facts. Two stand out in particular. First, Canada has virtually no trade link with Latin America. Surely only the special dynamics of a free trade agreement will change that. Second, intra-Western Hemisphere trade is very small. That raises the question whether North-South integration will change substantially 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 much (in fact, more than half) of the US-Western Hemisphere link reflects the special U.S.-Mexico relation. This immediately invites the question whether direct neighborhood effects have a very special role that cannot be achieved by simple free trade.

Table 2 Export Patterns: 1991
(Bill \$US)

	Exporting Region		
	U.S.	Canada	West. Hem.
To:			
U.S.	-	95.6	57.6
Canada	85.1	-	4.0
Western Hem.	63.5	2.4	21.0
World	421.8	121.2	140.4
% of GDP ^a	7.0	24.2	13.6

^a1989

Source: IMF Directions of World Trade

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 manufactures imports.

FREE TRADE AMONG THE AMERICAS: THE U.S. PERSPECTIVE

Several important trends in the world make pursuit of an Free Trade Agreements among the Americas an important, productive trade strategy. The arguments are first advanced from a U.S. perspective.

- Latin America is potentially an important trading partner; yet, the economies for the most part still very closed. Except for the lead of Chile, the process of unilateral opening is just getting underway now. But the starting point is one of very severe restrictions by huge tariffs, pervasive quotas and impermeable permit systems. Consider, for example, tariffs in Argentina:

Table 3 Average Tariff Rates
(Percent)

1976	1980	1989	1991
55.9	27.8	23.8	9.4

Source: GATT (1992)

Another way of measuring this closedness is to look at 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 or Mexico who have opened up and Brazil or Argentina is striking.

Table 4 Imports Per Capita
(\$US)

	World	U.S.
Argentina	244	69
Brazil	153	36
Chile	574	118
Colombia	172	65
Mexico	535	379
Venezuela	467	231
Korea	1875	443
Turkey	335	39
Philippines	203	42

The counterpart of this closedness is that there are important markets which, if open, 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 American 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 there at a far more ambitious pace. The merging of EFTA and the EC and the creation of a "European space" are projects that are already off the drawing board and way into realization. The creation of 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 which create precedents, blueprints and competitive forces that help drive a broader liberalization effort.

- Latin America represents a national security interest and as such deserves attention. 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. One only needs to contemplate the risks of Latin America turning

in the direction of poverty and destitution experienced in Haiti to recognize that there would be serious risks, certainly in terms of migration, for the rich North. With the spreading of democracy in Latin America, U.S. concerns have focused on deepening democracy and broadening the focus of trade policy to economic and special objectives including in particular labor standards and the environment. Opening and modernization of Latin America through trade and investment links 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 certainly force lower standards for workers and for the environment.

- Latin American also is our fastest growing market. Of course, free trade with Latin America cannot be a panacea for economic U.S. problems; but even if Latin America is not most of the solution of our problems, it still is an important market and our trade posture has important implications for their prosperity and hence our security. It would be a mistake to write off Latin America as an important partner.

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 economic growth in the years to come will be substantial. If Latin America recovers economically, and the United States can certainly invest in that prospect, there is ultimately a very significant market for U.S. exports.

To understand the prospects of an opening of markets in the South, the Mexican trade liberalization is of interest. It highlights two features. First, LDCs' markets are extraordinarily closed and hence, in a situation of trade liberalization, offer a potential for very major 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 more privileged status, at least for a while until a move toward multilateralism comes about.

It might be argued that the Mexican gains are already in place and that Mexico is one of the larger countries so that there is little left. Of course, there is Brazil which is far larger and offers a very striking opportunity in the perspective of the next 20 years. Brazil does have a strong interest in unimpeded access to the U.S. market and it offers an important market for U.S. exports in return. The current level of trade with Brazil is far below the potential of the country as a market. This point is quite apparent from Table 5. Brazil ought to be opened up.

Table 5 U.S. Trade: 1991
(Bill. \$U.S.)

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

Source: IMF Directions of World Trade

Trade and Employment Effects: The controversy surrounding the proposed 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". This view was advanced by Thomas R. Donahue, Secretary-Treasurer, AFL-CIO in the following terms:

"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 do little to help the vast majority of Mexican workers."

Specifically, according to opponents trade opening with Mexico and beyond would have two effects: the immediate loss of jobs, and further down the road more job losses once investment in Mexico has established

alternatives to U.S.-located production, and declining real wages in the United States.⁴ Any job losses are bad news at a time where real wages are depressed and employment at best stagnant. But these issues must not become an argument for stopping a good move in trade policy, which creates good jobs at home. The Clinton Administration is now committed to the implementation of Nafta but organized labor and other groups opposing trade liberalization are far from accepting the situation.

Even if trade liberalization inevitably causes some dislocation, that must not mesmerize us into maintaining the status quo for poor jobs. It is bad trade policy to keep workers and their children in poor jobs and even pervert protection to the point where we attract immigrants to perform this work. We should not let go of competition. But, equally important, displaced workers should get adjustment programs, skill building and education to help them get into good jobs. We do not do an adequate job in this area. The scope for worker training and adjustment assistance should be enhanced and broadened to include both trade and productivity-caused losses in jobs.

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

Concerns about the effect of free trade on U.S. jobs focus on the low level of Mexican labor cost. True, Mexican labor costs far less than U.S. labor but that is true with and without free trade. Short of closing our economy we will be unable to escape from the increasing ability of developing countries to produce manufactures at a highly competitive prices. But we can turn to our advantage the situation by gaining access to their markets with our goods. The dramatic effect of opening up of Mexico for our exports is already amply demonstrated by the experience of the past four years.

Table 6 U.S. Nonoil Trade With Mexico and U.S. Job Creation
(Billion \$US)

	US Exports	US Nonoil Imports	Net Nonoil Trade Balance
1986	12,391	14,040	-1,649
1990	28,375	25,206	3,169
Net US Job Creation: 1986-90			
	30 Jobs per \$1 Mill		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 Mexican labor costs are low relative to those in the United States, these labor costs also reflect in many cases a low level of productivity and in some areas such as textiles the very low quality of output. The quality factor especially is a major obstacle to a dramatic development of Mexican exports.

Third, the United States is a very open economy. Competition from abroad is not a threat but a reality. Protection continues only in a few sectors, not across the board in all lines of activity. Moreover, Mexico already enjoys a privileged position both as a result of the GSP and more importantly as a consequence of the maquila program which exempts reimports from U.S. duties except for the Mexican value added component. The combination of factors reduces the extra impact of U.S. trade liberalization to a few sectors and to a total effect that has simply no chance of amounting to much in terms of aggregate employment or output. And what goes for Mexico also goes for countries in Latin America.

In the 1980s, a vastly overvalued dollar brought about abnormal import competition and hence job losses and a reduction in real wages in

the U.S. labor market. No doubt, some of the competition came from Latin America and hence helps explain the 0.5 to 1 percent decline in real wages attributable to import competition.⁵

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

Who is Ready? We conclude with a brief look at the argument that a free trade agreement among unequals is not only a new idea, but a bad idea. A common objection to a free trade agreement with Mexico, but even more so with other countries in the Americas is this: they are not ready.

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

Not ready means in this context that their economies are too unstable, their politics insufficiently settled, their standards of living too low-- all of these or some. The argument has also been made from the South, Chile has argued that it is ready, whereas other countries in the region are not yet.

Superficially the argument is appealing, but in substance it is absurd. The response surely must be that the United States is interested in export markets and in 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 more intensive trade and investment links will help promote freer societies, more stable ones and more prosperous ones. Hence, particularly for economies where much is to be accomplished -- notably Brazil-- the perspective of an FTA raise the ante and will enhance and speed up 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, the spreading of a modern business culture which ultimately is utterly incompatible with closed, politically opaque societies are a fundamental U.S. aim and,

indeed, a U.S. contribution to the region. Who needs it most-- clearly countries like Brazil, not a country like Chile that has gotten their the hard way, but has made it. 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.

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 a modern, stable economy. 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 amply apparent.

Table 7 Asian Economic Growth

	1971-80	1981-90	1991	1992	1993
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 averaged to a very poor record. There are growth spurts to be seen in Chile, Argentina, and Venezuela. But, in fact, only the first of these has accomplished a deep and convincingly lasting reform effort.

Table 8 Latin American Growth

	1981-91	1990	1991	1992 ^a
L.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

^aForecast

Source: ECLA

What role can trade integration play in improving reform and growth? Assessments of the South's benefits range from big stakes to almost nothing. 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 U.S. Congress is 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 else as a 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 quite minor. These authors conclude that where trade is not restricted by quotas, duties are low and hence trade is substantially unrestricted at least in what regards 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 non-tariff trade restraints would be more of an issue. But even these hindrances might be passing in the context of a successful Uruguay Round.

These minimalist estimates are worth knowing about, but there is no reason to believe that they give a realistic portrait of the effects of an FTA. In part, of course, the trade effects derive from the immediate

removal of obstacles. In fact, however, the trade effects are much more sweeping when they come from an entire re-orientation of the region to become a modern, outward-oriented and 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 the following: removal of trade impediments, guaranteed market access, more assured modernization, and improved access to foreign direct investment. We comment on each in turn.

- 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. but even so, these are not formidable tariff barriers by any stretch of the imagination. Still, getting exemption from these duties will yield a preferential 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
Fin. Manufactures	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, leather footwear are ordinarily high on the list as are cheap glass ware and some 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, more so if it lies ahead decade or two ahead.

- 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 U.S. 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 a U.S. slide 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 for all future. 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. that is where productivity gains become startlingly large and where the fixed costs of modernization are more easily amortized and hence more decisively incurred.

- Modernization is not a process that inevitably gathers momentum, moving forward with growing strength. Venezuela and Brazil have

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

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, arguably, a quite irreversible one. Institutionally the provision of open access in goods, services, and investment opens up a country's ways of doing business 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. Competition forces without any question whatsoever the modern, international mode.

In Mexico one can see quite patently 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. Only 10 years ago nobody would have thought that sleepy Chile could be one-up on sophisticated Argentina. But in fact they are and one can only applaud.

The modernization carries over in an important way to business-government relations. Cumbersome and costly regulation becomes a burden to

competition and will be thrown off. Arbitrary government intervention makes firms uncompetitive and must go. 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, restrictions on individuals' freedom and prosperity. This is a dramatic effect.

- Foreign resources in the form of direct investment serve 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 more established 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:

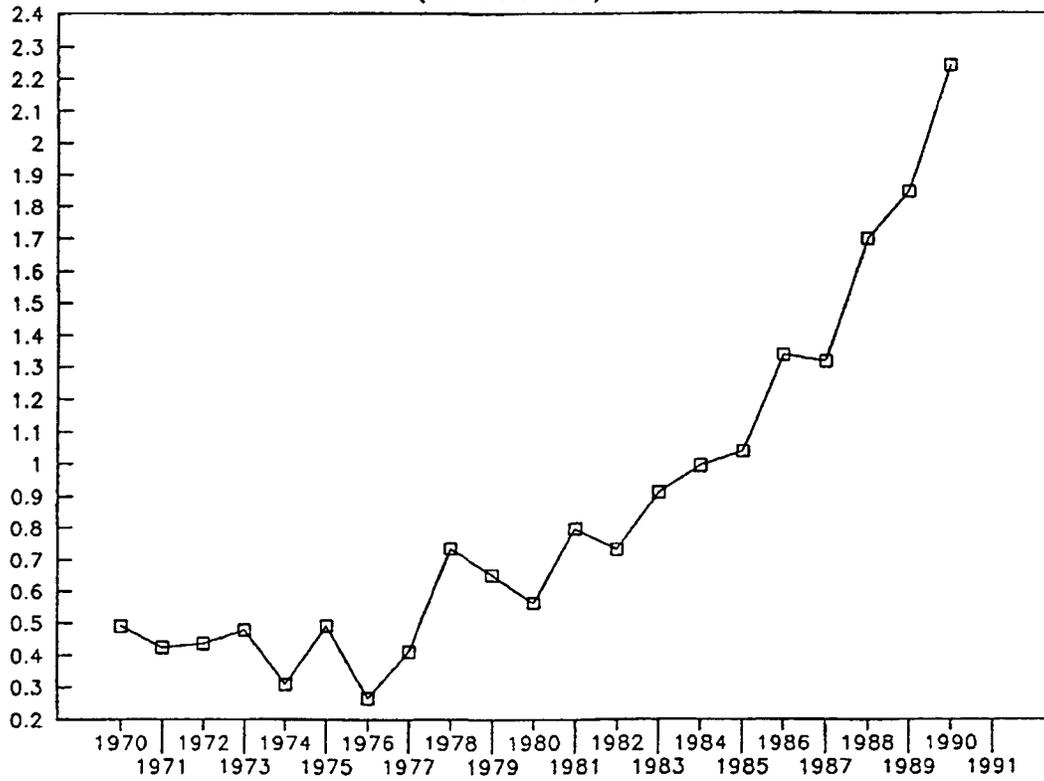
What are production costs in the region? and What is the market access from that region. On both counts, a free trade agreement is favorable. On the cost side import liberalization is likely to reduce production costs. On the market access side it offers assurance that there will not be random or systematic reversal of opportunities to sell into a partner country market or specifically into the U.S. market.

What evidence is there to show that foreign direct investment is attracted by a trade integration situation? Spain serves as a case in point. Figure 2 shows direct foreign investment in Spain over the past 20 years. Measured as a share of Spanish GNP, 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 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 itself is in part at least the result of joining the Common Market.

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.

FOREIGN DIRECT INVESTMENT IN SPAIN

(Percent of GDP)



WHAT MODEL FOR INTEGRATION?

Latin America has been trying to achieve trade integration within the region already for a long time. It would be difficult to call the 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 already by 1994.

The great difficulty in negotiating regional arrangements is where to start. One position is defensive: try and string out protection and 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, looked at from 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 or 15 years are very short and full free trade comes irreversibly at the end of the tunnel.

A useful approach to Latin America would be to target Mexico and the Southern Cone group (Brazil, Argentina, Uruguay) for a free trade area, including if possible 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 who ultimately may be members but are not in the early rounds at the

negotiating table. This argument enhances the case for a blueprint negotiation with Mexico and for an early and short window of time during which other countries can adhere. Anything more than a 2 year period would be unnecessarily and unproductively long.

The fast track approach is clearly the right way of proceeding. 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, or worse. The Caribbean with its exception of sugar, textiles and more is a case in point. In a setting other than fast track it is virtually a foregone conclusion that politicians will have to seek "relief" for their customers and special advantages; they will be judged not by the total result but by the deviation from the norm that they can secure. The result, unfailingly is a worthless agreement.

Even as an FTA with Mexico is being concluded, it must be made clear that Latin America should practice opening and clearing the trade field of the myriad of obstacles in place today. Countries like Brazil have a lot of work to do in removing the extensive controls on trade and the tariffs. Other countries like Chile or even Argentina are already far ahead.

The best approach is to focus on large blocks, and the Mercosur is clearly the most interesting, and to bring them in fast. For isolated

countries whether it be 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. Specifically that means three things:

- Elimination of any quotas or other non-tariff barriers.⁷
- Full inclusion of all services in the liberalization process.
- Investment is an integral part of the liberalization effort.

The review of the U.S. Advisory Committee (ACTN) of the US-Mexico agreement offers a solid blueprint of just how ambitious the targets should be.⁸ If an extra road of trade policy, in addition to GATT,

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

⁸See Advisory Committee (1992).

is to be opened there must be an important payoff. The only possible payoff is a far more ambitious agenda than what today can already be accomplished at the multilateral level.

THREE CONCURRENT PROCESSES

In concluding it is important to emphasize the complementarity of three approaches: GATT and the Uruguay Round, unilateral trade liberalization, and a an Americas Free Trade Agreement. The first is a worldwide strategy. Each country in the region has important extra-regional interests and for that reason must be concerned that the world economy sustains open markets and broadens the opening of markets. A regional emphasis alone is not enough.

The Americas FTA is critical because it carries trade liberalization much further than can be done at the world level: the coverage of liberalization --goods, services, investment-- is more substantial and the liberalization more complete. Being in is essential in order to avoid concentrated trade diversion effects.

Lastly, 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 U.S. 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 in unilateral liberalization. But it is essential to let the FTA and the unilateral moves go hand in hand to minimize the unnecessary and undesirable trade diversion effects.

The three-pronged strategy as described here is favorable for the world economy. It produces more trade, less protection and hence a greater scope for multilateral opening over time. No apologies need to be made for freer trade, -- unilateral, regional and multilateral.

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