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Economic Commission for Latin America and the Caribbean

FACTORS AFFECTING THE PARTICIPATION OF CARIBBEAN COUNTRIES IN THE FREE TRADE AREA OF THE AMERICAS

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ABSTRACT

This paper is intended to assist the Caribbean countries in their preparations to enter the FTAA. It takes as its point of departure the fact that all of these countries are acutely conscious of their small size, judged by one or all of the criteria of land area, population or Gross Domestic Product. The paper recognizes that concern about their small size and the consequent handicap which this is seen to confer in a world of giants, fuels the deep sense of insecurity which permeates many of these countries as they prepare themselves to face wider hemispheric markets. Paradoxically, it also impels them to join a larger trading group for fear that they might otherwise be denied a place in the mainstream of international activity. However, while small size, per se, may not necessarily imply any inherent disadvantage it should not provide any justification for them to shrink from market opening, especially since this opening is, in the medium to long term, likely to confer commensurately greater benefits to these countries, precisely because they are small.

Several characteristics of small size are discussed, especially those which seem especially relevant to the Caribbean. The paper notes that small size does place greater demands on the national leadership, for appropriate and consistent economic management. Moreover, it does dictate that the citizens of small countries live with higher levels of risk, be it risk derived from the vagaries of the weather or from the turmoil of international markets. It also recognizes that the range of production options open to small countries is inherently limited and that the ***transitional*** costs of entry to the FTAA might be high, especially as some Caribbean countries have been pursuing policies which went somewhat counter to the new requirements.

Focus is, therefore, placed on the lack of ***preparedness*** of many small countries and proposals are made as to internal and external policy options which might be chosen to better prepare them for accession to the FTAA. Several measures are also suggested which small countries might seek to secure in the FTAA negotiations, so as to mitigate the short-term transitional costs of entry and enhance their ability to participate in the new grouping. These should focus on three categories: internal policies; measures to increase the production of exportables; and, joint negotiating strategies.

I. INTRODUCTION

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

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

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

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

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

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[1] Summit of the Americas, December 9-11, 1994, Miami, Florida - Plan of Action.

The FTAA covers a large number of potential member countries,[2] which display wide differences in population size, land area, economic structures, resource endowments, levels of income, levels of skill and technological development, quality of basic infrastructure and productivity. These differences are stark, between the industrial countries and some of the developing countries potential members of the proposed grouping. Significant differences also exist among the developing countries themselves, which include small and large economies at different levels of development.

Small size does not confer an inherent economic disadvantage. But it does limit the range of development options available to the policy-maker, since small countries have intrinsically open economies which are highly dependent upon trade. This means that policies which encourage an efficient interaction with the international economy are amply rewarded, while policies which do not are severely penalized. Examples of both types are to be found globally and also in the Caribbean. Examples of the former include Singapore, Taiwan, Hong Kong or Luxembourg, while in the Caribbean examples can also be found of small countries, some very small, which have achieved relatively high standards of living derived from their trade in financial and tourism services. The Bahamas and the Cayman Islands provide two such examples.

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

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

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

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

CARIBBEAN COUNTRIES

Selected indicators for 1994

Country	Export[a] Concentration(%)	Merchandise Trade/G.D.P. (%)	Merchandise and N.F.S./G.D.P. (%)	Trade Taxes/Tax revenue(%)	Unemployment Rates (%)
Anguilla	...	55.4	146.9	77.0	...
Antigua/Barbuda	...	75.8	152.6	66.1	5.7
Barbados	23.3	54.8	95.7[b]	8.6	21.2[f]
Belize	34.1	79.2	128.0	54.4	9.8
Dominica	47.9	79.3	124.5	56.5	9.9
Dominican Republic[e]	25.3	32.9	62.7	44.8	...
Grenada	9.3	58.6	99.1	56.9	15.3
Jamaica	78.4[c]	78.6	101.9[b]	14.0	15.4[f]
Montserrat	...	41.5	77.3[b]	52.5	5.5
St. Kitts/Nevis	40.7	65.2	144.5	55.2	4.7
St. Lucia	49.3	69.3	113.9	58.7	7.2
St. Vincent	29.0	70.0	90.5	50.6	17.9
Suriname	57.4	77.1	92.8	41.7	...
Trinidad/Tobago	75.5[d]	55.8	61.9	10.4	18.5[f]

Source: ECLAC, derived from national data.

[a] Major export as a percentage of merchandise exports.
[b] Refers to Goods and Tourism earnings only.
[c] Refers to Bauxite and Alumina.
[d] Refers to Petroleum and Petrochemicals.
[e] Refers to 1993.
[f] Refers to 1994, remainder based on most recent data.

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

The small size of domestic markets prevents firms operating in these markets from taking advantage of economies of scale or increasing returns to scale in those industries which are scale sensitive.[3] Conversely, when they attempt to take advantage of such economies they are required to capture export markets from the outset, denying them a familiar domestic market in which to perfect their craft. In reality, industries developed in the Caribbean tend to be highly protected and their production destined mainly for the domestic market, or the regional market in the case of CARICOM member countries.[4] The quest for reduced tariffs is complicated by the heavy reliance of some countries on trade taxes for their revenues. Import taxes contribute more than half of tax revenues in the OECS countries and Belize, being as high as 66% in Antigua and Barbuda. In Barbados, Jamaica and Trinidad and Tobago, where tax reform policies have been implemented reliance on trade taxes is much less, ranging from about 9% to 14% in 1994. However, early efforts by Grenada to reform its tax regime were set back by difficulties in collecting consumption taxes.

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

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

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[3] See De Vries, Barend A, Industrial Policy in Small Developing Countries: Issues in Determining an Appropriate Strategy (Finance and Development, June 1984).

[4] The same levels of protection do not exist in Central America. See Lewis, D. "Assessment and Review of the Central American Negotiations Toward The Nafta and Their Possible Implications for CARICOM Trade Negotiation Initiatives", in Report on the North American Free Trade Agreement, G.S.R. Associates, Port of Spain, Trinidad, 1994.

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

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

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

II. APPROACHES TO THE ISSUE OF UNEQUAL GAINS IN VARIOUS TRADE AND INTEGRATION SCHEMES

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

A. THE TREATMENT OF LESS DEVELOPED COUNTRIES IN THE EU

Two basic mechanisms are used to deal with structural diversity within the Union.[5] The first concession is a transitional period to allow a member country to adapt its national legislation and standards to Union levels and practices. This implies that sectors considered to be particularly weak in given countries might delay their full exposure to competition from other Union members for several years.[6] The second concession, parallel and often longer lasting than the first, relates to the EU Structural Funds Programs. Despite the objective of reducing disparities among regions of the Community appearing in the very preamble of The Treaty of Rome in 1957, the Funds came into being against the backdrop of the Single European Act's statements about "market solidarity" in 1988. They were also prompted by the increase in structural diversity in the Union after the second enlargement, to include Greece in 1981 and the third enlargement, to include Portugal and Spain in 1986.[7] In their several forms, the Funds demonstrate a

[5] Countries singled out for special treatment are Greece, Ireland, Portugal and Spain.

[6] Specific sectors like banking and finance, received "transition periods" of up to seven years in Portugal and Spain. The Common Agricultural Policy (CAP), is also a concession though with a Union wide constituency and "permanent" status.

[7] The importance of the Structural funds can be assessed by their sheer size, 60 billion ECUs or US$ 80 billion for the *quinquennium* 1989-1993. The Funds can also be seen in relation to the economies of the recipient countries, where they represented 2.3% of GDP for Greece, 2.9% for Ireland and 3.5% for Portugal, for the period 1989-1993.

real effort at convergence, via efficiency improving mechanisms, to promote market conditions where they do not exist and assist in the provision of public goods in short supply.

B. TREATMENT OF THE LESS DEVELOPED COUNTRIES IN CARICOM

The principle, of special treatment for its Less Developed Country (LDC) members,[8] is also well established within the CARICOM, where a special regime for the LDCs was created to provide them with preferential treatment in the integration process. They were allowed a 10-year adjustment period to implement the Common External Tariff (CET), double that which was allowed to the More Developed Country (MDC) members. They were also given a 10-year grace period before being required to engage in free trade with the MDCs of the Community. They were allowed to suspend temporarily, the implementation of the CET to promote a particular domestic industry and suspend common market treatment for imports from the MDCs, if major revenue losses were likely to result from such treatment. In addition, LDCs were given special concessions under the rules of origin, where groups of products which figured prominently in their production, such as processed fruits and galvanized sheets, were granted common market treatment on concessionary terms. In this instance the percentage of foreign inputs was set higher than that for the MDCs.[9] The LDCs were also allowed to use direct and indirect export subsidies in regional trade to discriminate in favour of domestic producers. Finally, the system of harmonized fiscal incentives for investment, allowed the LDCs to provide investors with longer tax holidays and tariff exemptions, usually 15 years, as compared to the 10 years allowed for the MDCs.

C. THE TREATMENT OF MEXICO IN NAFTA

Despite the principles of reciprocity under which NAFTA was negotiated, Mexico benefited from special treatment in selected areas. For example, differential phasing periods were agreed, to protect Mexico from surges in imports from its more developed partners. The agreement stipulated that the proportion of Mexican imports entering duty free would only represent 43% of its non-petroleum imports from the United States and 41% of these imports from Canada.[10] Nevertheless, 84% of Mexico's total non-petroleum exports to the United States and 79% of those exports to Canada would benefit from duty free entry, with effect from January 1994.

In the case of textiles, it was agreed that the United States would begin by eliminating tariffs on 45% of its imports from Mexico, while Mexico need only eliminate tariffs on 20% of its textile imports from the United States. Concessions were also given to Mexico with regard to the automotive sector, where approximately 81% of Mexico's exports of parts to the United States would enter duty free upon the coming into effect of the NAFTA, while only 5% of the United States exports of parts and

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[8] Those identified for LDC treatment within CARICOM are Antigua and Barbuda, Belize, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. The MDCs are Barbados, Guyana, Jamaica and Trinidad and Tobago.

[9] "The Caribbean Common Market —Trade Policies and Regional Integration in the 1990s". World Bank Report No. 8381— CRG, December 21, 1990.

[10] These percentages were based on the value of trade in 1991.

components to Mexico would enter duty free. With regard to agriculture, the United States agreed to begin by removing tariffs on 61% of agricultural imports from Mexico, while Mexico would be expected to remove tariffs on only 36% of its agricultural imports from the United States.[11] Nevertheless, these concessions were intended to be temporary and the agreement included a time limited schedule during which the liberalization of trade in all sectors would take place.

[11] "Conclusión de la Negociación del TLC", Sera Puche, J.; El Economista Mexicano, October - December 1992.

III. POTENTIAL BENEFITS OF MARKET OPENING

It is well known, though not universally accepted, that free trade improves efficiency and welfare. Simply stated, trade permits a country to specialize in doing the things it can do most productively, maximizing its earnings by exchanging a portion of its production. Imports, in turn, free a country from having to produce all the goods and services necessary for its survival, many of which it would be physically incapable of producing, while most of the remainder it could only produce at very high cost. With free trade, production at home can concentrate on the most efficient activities, while the remaining national needs can be satisfied by those abroad who produce them most competitively. Welfare is, therefore, maximized by trade, since all parties benefit. While the argument evolved in the developed countries, it is more germane to the small and less developed ones since they stand to benefit most from trade. Nevertheless, small countries have a relatively greater need for secure market access and stable and transparent trade rules, if they are to be able to trade effectively.

In recognition of these principles the GATT was formed, to encourage the development of multilateral trade and to define and administer the rules which should govern it. This mantle has now been assumed by its successor organization, the WTO. Several regional trading arrangements have been spawned since the establishment of the GATT. While they diverged from pure multilateral principles, they were usually accepted as a second best option by the GATT.[12] This acceptance came in part because the regional trading arrangements had the potential to move member countries more quickly toward the goal of multilateralism, than might have been possible by unilateral action. The FTAA also holds this potential, since it could establish a free-trade area to encompass most of the trade in goods and services for most of the countries in the hemisphere. The alternative, of unilaterally achieving the same degree of trade liberalization, via the GATT route, is less likely to be realized, given current attitudes. This is especially true for the smaller countries, since small clusters of them have long standing commitments to limited trading arrangements among themselves. Moreover, the principles and attendant risks of multilateral trade are not embraced by all of them.

Trade liberalization is currently being reintroduced by some of those countries in the Caribbean which experienced the most severe economic disequilibrium in the 1980s. For them, as for all small economies, export earnings play a pivotal role in their economic expansion and increased earnings became especially critical if they were to meet their outstanding external debt obligations. Supporting evidence for this proposition was provided by the success of some other small countries which were successful in

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[12] Article XXIV outlines the conditions under which Integration is deemed not to be in breach of the GATT regulations. Efforts were subsequently made, leading up to the WTO, to define these conditions more precisely.

achieving export led growth.[13] Improved export performance was adopted as the means to establish equilibrium and achieve sustained growth. Policies to favour the production of tradable goods and services over non-tradables were applied, beginning with measures to increase economic efficiency and reduce the various policy biases against export activities. These began with restrictive fiscal and monetary measures and realignments of the real exchange rate. Subsequently, exchange rate regimes were often modified to ensure that the market would play a greater role in determining rates than hitherto, in the hope of avoiding the gross misalignments which had developed when rates were administratively fixed. Once domestic demand was contained, these governments felt sufficiently confident to focus on several medium term policies, such as the foreign investment codes and deregulation of the financial system. Labour market policies have not yet been approached in any systematic manner, yet this seems warranted in view of the chronically high rates of unemployment in some countries. Nevertheless, dialogue between management and the trade unions has led to improved communication between the social partners.

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

Entry as a group into the wider FTAA is likely to provide a more feasible means of reducing trade barriers among the small countries.[14] It has the benefit of providing some continuity with past policies, permits the maintenance of solidarity between existing membership and the retention of some of the security which the existing arrangements are believed to confer. It is also seen as a means of extending the policy scope available to those seeking to maximize economic efficiency and the export thrust. Simultaneously, widening increases the market size which is deemed to be necessary by some if the export thrust is to be successful.

Greater market access is seen to be desirable because the CARICOM market is inherently small and further constricted by those demand management policies necessary to sustain equilibrium in the face of their sluggish export performance. Increased market size, in conjunction with uniformly low tariff rates and liberal rules of origin, will reduce the incidence of trade diversion and provide economies of scale. Widened market access, within the context of a formal agreement such as the FTAA, is likely to reduce uncertainty in the regulations governing the trade in goods and services and yield transparent mechanisms for dispute settlement. These are all factors of enormous benefit to small countries which do not have

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[13] Notably in Asia, where trade liberalization was pursued in a non-discriminatory manner, rather than through regional trading schemes. Accordingly, they avoided the worst faults of Import Substituting Industrialization, which at best had only a very limited utility within small market areas.

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

market power to bolster them in trade disputes.[15] Finally, for a small country facing the risk of domestic policy reversals, binding the policy fundamentals in the framework of a multilateral arrangement can have the benefit of increasing policy consistency. Trade liberalization, which has been resisted in some Caribbean countries, could, therefore, be reinforced or accelerated as a result of participation in the FTAA.

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

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

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

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

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[15] For example, The Omnibus Trade and Competitiveness Act of 1988 is used by the United States to decide unilaterally and apply, or threaten to apply, trade sanctions against those countries it regards as unfair traders.

integrity of the group[16] and allow for the joint resolution of issues of common concern. It would also simplify the negotiations for all parties if the total CARICOM membership negotiated as if it were one entity. To be weighed against these benefits is the risk that the uneven pace of economic reform within CARICOM might complicate its internal preparations for the negotiations and jeopardize the chances of entry of the whole group, unless rapid progress can be made on the major potential sticking points, notably the CET.

[16] To pursue the range of beneficial activities in areas other than trade that will remain after entry to the FTAA.

IV. POTENTIAL COSTS OF MARKET OPENING

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

The political question of reduced sovereignty may also have economic implications, even in seemingly straightforward commitments such as, "a country seeking to enter an FTA with the US should be committed to a stable macroeconomic environment ... ".[17] This requirement implies a limit to the application of counter-cyclical polices favoured by some governments, even without explicit and strict benchmarks such as those set by the EU's convergence criteria. Similarly, the Supplemental Agreements of NAFTA, especially those covering labor practices and environmental standards, can affect the relative attractiveness of some countries for investment and entail significant costs in their application in small countries.

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

Potential losses are usually considered to be limited to the short run, since some factors of production, such as workers trained to perform distinctive tasks or factories built to produce unique goods, are specific. Specific production factors are those linked to a given production process that can be rendered uncompetitive by the opening up of an economy and are not easily or immediately transferrable to other uses. In the long run, however, all productive factors are assumed eventually to adjust to market signals, that is, they find alternative adequate uses, resulting in an optimal, equilibrium configuration. This argument recognizes that there are always relatively competitive sectors, for in the

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[17] See "Report on The North American Free Trade Agreement", vols. I and II; G.S.R. ASSOCIATES, Port-of-Spain, Trinidad, 1994.

framework of the Ricardian Comparative Advantage theory, while it is possible for a country to be absolutely less competitive in all sectors, it is impossible for any country to be relatively uncompetitive in all of them. Therefore, even where all sectors are absolutely less competitive than the global best, all the domestic agents are potential winners from trade, since the relatively more competitive sectors can generate the resources to compensate the potential losses of relatively less competitive sectors through various transfer schemes.[18]

When analyzing the trade effects of economic integration, economists usually consider three categories: trade creation, trade diversion and gross trade effects. Trade creation is defined as the development of new trade flows among members of the new economic area that displace previous high cost domestic production, trade diversion as the substitution of low cost imports from third countries for high cost imports from member countries. Gross trade effects are the result of the two, and represent the net trade effect of the preferential trading area on itself and on the rest of the World.[19] From the view point of global welfare, any integration short of global integration is sub-optimal.

There are, so far, few estimates of the concrete effects of NAFTA on the smaller economies. One estimate finds that the new market conditions offered to the Mexican textile producers had no negative effect on the Central-American textile sector. Negative effects did arise from the competition between Central-American countries in an export-oriented sector with homogeneous products and a high substitution elasticity. In this particular case, the net trade effect was zero for these economies outside the trade bloc.[20]

Another study, quoting estimates from a World Bank report, forecasts some reduced static and dynamic losses from NAFTA non-membership for the CARICOM countries. The static losses were concentrated in certain countries and sectors, for example, for Jamaica and the clothing, apparel and footwear sectors. Nevertheless, most of the NAFTA effects appeared in the dynamic estimations, those incorporating the long-term effects of increased market scale and efficiency allocation, when there is projected a clear reduction of growth rates for all Caribbean countries outside the unified trade area.[21]

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[18] The classical exception to this is the famous case of "Immiserizing Growth", developed by Bhagwati, J., in his 1958 paper. This is today considered to be a largely theoretical possibility. See Krugman, P. & Obstfeld, "International Economics: Theory and Policy", MIT Press, Mass., USA, 1988.

[19] See "A Note on Predicting the Trade Effects of Economic Integration and Other Preferential Trade Agreements: An Assessment", Markheim, D.; Journal of Common Markets Studies, vol. 32, No. 1, London, U.K., March 1994. This study, calculates that the net trade effect on US-Caribbean imports between 1987 and 1993 was 99.9%, or that the increase was virtually totally created by CBI preferences.

[20] That means that those countries could probably remain competitive in the sector in the short run, but once one of them entered the preferential trade area unilaterally, the outsiders would all be losers. The adequate optimal game strategy would be for them to negotiate and enter as a regional bloc. See CEPAL, "Análisis Preliminar de La Relación entre El Cambio Arancelario y El Comercio: Impacto de La Desgravación en El TLCAN en Las Exportaciones de Los Países Del Istmo Centroamericano", CEPAL, Mexico City, Mexico, 1995.

[21] "An Analysis of Quantitative Estimates of the Trade and Investment Impacts of NAFTA", McIntyre, A.; in "Report on The North American Free Trade Agreement", G.S.R. Associates, vol. II, Port-of-Spain, Trinidad, 1994.

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

Conclusions with respect to the services sector are somewhat less clear. The tourism industry is already relatively open and competitive, although some ancillary services in the industry could be vulnerable to external competition.[22] Opening the financial sector could also signal a displacement of some domestic firms, or at least trigger some form of association with foreign enterprises.[23] Telecommunications facilities in most countries are either foreign-owned or operated in joint ventures with foreign companies. Nevertheless, in the telecommunications sector, which has a tendency to monopoly especially in small countries, as well as in the financial services sector, new entrants to the market might increase efficiencies and the pace of technological change. Finally, it should be noted that services were also partially covered by the Uruguay Round of GATT negotiations and are likely to undergo further liberalization waves through the WTO.

Additional concerns might also arise from: (a) the fiscal importance of import taxes in some countries in the region, since any harmonization process that changed tariffs significantly could mean short-term budgetary difficulties and/or the need for concomitant tax reform measures; (b) a conflict with existing preferential structures, the most quoted but by no means the only examples, being the incompatibility of the Lomé Convention or the Caribbean Basin Initiative (CBI) with a hemispheric free trade area, although again this framework is already under question due to EU developments and aforementioned GATT/WTO commitments; (c) from the costs related to the harmonization of patents and copyrights, which could entail increased financial transfers abroad and the loss of freedom for domestic agents wishing to establish new business, but this is also a question that will be addressed on a global scale, through the GATT/WTO; and, (d) from the financial and human cost of administering any integration organization, although this is expected to be relatively light in the case of the FTAA.[24]

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

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[22] Although, major changes in national market shares are likely to result from the full integration of Cuba in the region's tourism industry.

[23] Scale economies are usually considered to be less important in the financial sector, where the existence of a widespread branch network and local knowledge of domestic market conditions act as a barrier to entry against major external competitors. Nevertheless, small domestic financial markets suggest a relatively small fixed investment in the network, while increasing interest in overseas operations could reduce the relative importance of domestic market knowledge.

[24] For example, the EU is financed by all its member States from a portion of their VAT and import duties, to the value of 1.21% of the Union's combined GDP for 1993. Most of these resources go to the Common Agricultural Policy (CAP) and Structural Funds programmes.

V. POLICY PROPOSALS

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

Many of the smaller countries currently obtain preferential trading arrangements which bolster their economies but at the same time inhibit the adjustment processes necessary for their effective incorporation into a wider free trade arrangement. This is particularly true of the traditional agricultural exports, notably bananas and sugar. But it also applies to some segments of the garment industry and most of the light manufactures and agro-industry produced for the regional market. In most of the smaller countries the cumulative effect of these preferences is to severely distort their production and consumption patterns. Efforts have, nevertheless, been made to push the adjustment process forward including the lowering of Common External Tariff and some of these distortions are being reduced. However, where individual preferences loom large in the economy, the underlying macroeconomic picture can be sufficiently distorted, that countries are able to postpone action on the adjustment of real exchange rates and measures to stimulate investment into unprotected exportables. At the same time, the ephemeral benefits of protection can be so great for the economy and social fabric that policy attention focusses on lobbying for their retention rather than on adjustment.

One way out of this vicious cycle is to decouple the financial benefits from, for example, banana protection away from banana production. This might be possible if the preferences, which have a finite life, could be phased out progressively, for example over a five year period, with the quantum of the preference reduced each year being transferred to an investment fund. This fund might be used for improving the efficiency of the protected industry or for investment in other exportables. Such reduction in the preference would encourage the least productive to begin to switch production immediately, while the reduced export earnings from the preference could be allocated for investment in other exportables. This mechanism might still create some distortions to the economy and caution would be needed to ensure that adjustment measures would be pushed ahead, to pay greater attention to the real exchange rate and otherwise encourage a positive investment climate. Where the protection was internally derived, say within a common market arrangement, some form of assistance, including help in tax reform where necessary, might be provided which would be conditional on the more rapid reduction of those preferences deemed to be excessively high.

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

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

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

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

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

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

b) Harmonization or acceleration of policies, as the case may be, within their respective integration arrangements to make them more consistent with domestic policy objectives outlined above.

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

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

e) Small countries face high unit costs in providing basic infrastructure, including public services. Special funding might, therefore, be sought to finance activities that will improve productivity across the economy as a whole, for example, to upgrade economic infrastructure and to improve skills training and basic education.

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

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

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

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

VI. SUMMARY AND CONCLUSIONS

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

Caribbean economies have traditionally been closely integrated into the global economy. This is not surprising since they are small and must rely on outside purchases to satisfy the majority of national needs. Past policies, which have attempted to attenuate this external dependence, have been counterproductive. They have so distorted production structures and damaged export performance that global interaction has been sustained, for some countries, only via preferential trading arrangements. Increasing globalization through the GATT suggests that preferential arrangements will be dismantled. Parallel developments taking place regionally, notably the formation of larger trading groups, also require that barriers to the trade in goods and services, financial flows and technology should fall within the group. The pressures to open Caribbean markets will be intense, in either circumstance. Several countries have anticipated these trends and initiated a process of market liberalization.

Preparations to enter the FTAA are consistent with actions which Caribbean countries would need to take to integrate efficiently into the wider global markets. The process leading to entry into the FTAA holds the prospect that small Caribbean countries can negotiate a systematic set of measures, timetables and safeguards to assist their adjustment. Access to a clearly defined larger market should help to remove some of the policy and market uncertainties which potential investors face, thus quickening the pace of investment needed to transform these economies. This process gives small countries the option of improving their preparedness in a climate of somewhat reduced risk.

Given that the smaller countries are less well prepared and are, therefore, likely to experience some difficulty in taking advantage of the potential benefits of the FTAA, they should organize transitional arrangements to help mitigate the short-term costs of entry. These should focus on three categories of action: internal policies; measures to increase the production of exportables; and joint negotiating strategies. In the first category, more liberal timetables should be sought so that domestic policies and, where relevant, policies within trade groupings, could adapt to the requirements of the FTAA. Special funding should also be negotiated as a substitute for current export preferences to provide an effective transition out of them. In order to increase the production of exportables, a development fund should be established to improve economy wide efficiency in areas such as infrastructure and training. Assistance should also be sought to develop joint ventures, production sharing arrangements and marketing skills and small countries should seek more liberal rules of origin, given their limited production possibilities and the importance of obtaining the most cost- effective inputs to production. Finally, they should strengthen their negotiating positions by forming joint negotiating teams, which should include stakeholders and persons having special expertise from the productive sectors.