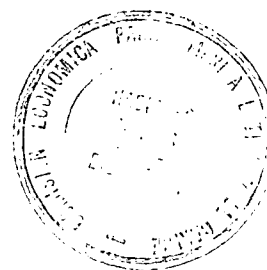


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Conditions for Maximizing the Gains from a Western Hemisphere Free Trade Agreement

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Conditions for Maximizing the Gains from a WHFTA

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

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

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

benefitted greatly as bystanders to tariff reduction and trade liberalization among the developed countries.

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

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

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

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

Just as that happened, however, many observers became skeptical of the ability of the developed countries to maintain open access to their markets. On one hand, there were clearly protectionist pressures emerging and strengthening in the domestic political arena in many developed countries. On the other hand, the Uruguay Round of trade negotiations - so named because of its importance to developing countries - was not brought to a successful and timely conclusion, but instead has dragged on without final agreement.

Concurrent with those ominous developments, regional trading blocs are apparently emerging. The European Community, although somewhat distracted by events in Eastern Europe and the CIS, is proceeding with its commitment to complete the internal market by the end of 1992. Simultaneously, after the U.S. and Canada signed a Free Trade Agreement (FTA), Mexico announced her intention to reach an accord on an FTA with the United States, and President Bush subsequently announced an Enterprise for the Americas, which envisaged a hemisphere-wide FTA.

The prospect of a Western Hemisphere Free Trade Area (WHFTA) presents both opportunities and dangers for Latin American countries. There is an opportunity for improving economic performance and accelerating growth if: 1) the WHFTA results in a further liberalization of world trade and access to markets for the Latin American countries, and 2) appropriate domestic economic policies are in place that permit domestic producers and consumers to avail themselves of the opportunities presented by such an WHFTA. There are dangers if: 1) the net result of regional integration arrangements is the emergence of trading blocs, with a disintegration of the world trading system; or 2) countries fail to adopt economic policies compatible with liberalized trade.

It is the purpose of this paper to assess the possibilities and the dangers, and to consider the sorts of policies that Latin American countries could adopt which would provide the maximum scope for gains under an WHFTA. A first section lays forth the framework of analysis, indicating the ways in which a country's trade regime affects its economic performance and prospects, the role of domestic economic policies in affecting trade outcomes, and the sorts of FTAs that would be more or less conducive to improved economic performance.

A second section then considers those aspects of an FTA that will be most crucial, from the viewpoint of the Latin American countries, in shaping the nature of future trading arrangements. As will be seen, these range all the way from the symmetry of trading relations, to such important but technical issues as rules of origin and dispute settlement mechanisms.

A third section then focusses upon domestic economic policies, and the ways in which the policy stance is likely to affect the outcome, for individual countries, of an FTA. A final section summarizes, noting the sorts of trade-offs that may arise in negotiations over an FTA from the perspective of individual Latin American countries.

1.A Framework for Assessing Alternative FTAs

In order to analyze the potential of FTAs from a Latin American perspective, a first question that must be addressed is the role of trade in facilitating Latin American economic objectives. Thereafter, attention turns to the ways that an FTA might facilitate or impede the contribution of trade to achieving those objectives.

For present purposes, it is assumed that Latin American economic objectives are those of achieving higher living standards and real rates of growth of their economies. It is well known that these are but means to ends, and that in fact

economic objectives are far more complex. However, most other objectives are functions of domestic economic and other policies, and little affected by trading opportunities. As such, it seems safe to analyze the problems and potentials of alternative forms of FTAs in light of their impact on economic efficiency and growth.

The Role of Trade in Development. By the late 1980s, there was a widespread consensus that an outer-oriented trade strategy can result in much more rapid and sustained growth than can import-substitution. While many questioned the ability of politicians to carry out the transition away from import substitution,⁴ few could doubt that if a country could successfully make the transition, the payoff could be large. Historically, first Korea, Taiwan, Hong Kong and Singapore, and later Thailand, Turkey, and Malaysia were achieving unheard of rates of growth over long periods of time by reliance on an outer-oriented trade strategy and domestic economic policies supportive of that strategy. Meanwhile, the countries that had persisted in import-substitution had experienced major slowdowns in growth and falling living standards, often accompanied by rapid inflation and major difficulties in servicing debt.

For purposes of analyzing the potential of an FTA, the important questions relate to the ways in which an outer-oriented trade strategy contributed to

⁴For an analysis of the political economy of trade liberalization and other economic policy reforms (many of which are essential if trade liberalization is to have the desired effects), see Bates and Krueger (forthcoming), Nelson (1990) and Michaelis, Papageorgiou, and Choksi (1991). The vested interests that build up under import substitution are sure to object to reforms, and political opposition has often led to reversals in reform programs before their benefits could be realized. That the payoff for successful liberalization can be enormous is unquestioned. For a comparison of Korea (which liberalized in 1960 when her per capita income was less than 1/3 that of Turkey) and Turkey (where import-substitution continued to 1980), see Krueger (1987).

economic growth in the successful countries.⁵ The answer has to do in part with the shortcomings of import-substitution - the small size of the domestic market, the inevitable tendency for heavily protected firms to become high cost in the absence of sufficient competition, the inability to use comparative advantage and the consequent necessity to move increasingly into capital intensive industries with their associated high costs and low incremental output, and the economic consequences of foreign exchange shortages.

But, for present purposes, the more important part of the answer has to do with the benefits of an outer-oriented trade strategy. These include phenomena associated both with the competitive stimulus to exports and with the access of domestic firms to imports from abroad. On the export side, it is evident that the payoff from adopting an outer-oriented trade strategy will be greater, the more open the world economy is to a country's products. In that regard, it is always easier to capture market share in the context of rapid growth than it is when new entrants must compete with existing suppliers for business. Many point to the rapid expansion in the international economy at the time that Korea and Taiwan were beginning their outer-oriented trade strategies as a major factor in explaining their rapid growth: once incentives were in place for exporting, domestic firms had little difficulty finding overseas markets.

The benefits, in terms of increased efficiency of resource use and of economic growth, of an outer oriented trade strategy are also clearly greater when the size of the domestic market is small and when a country's resource endowment diverges significantly from the median in the world economy. A small size of domestic markets generates larger benefits from liberalizing trade

⁵The reasons can only be briefly summarized here. For further analysis, see Krueger (1984) and Bhagwati (1988).

because of the increased impetus to economic efficiency that arises from competitive forces after opening up, and also because firms confronted with small domestic markets are likely to have high fixed costs.⁶ It is widely thought that the increased competitive pressure is also important in driving down costs, although empirical evidence is sketchy on this point.⁷

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

Role of the International Economy in Facilitating Development. Much of the benefit from shifting to an outer-oriented trade strategy (and the other economic policies necessary to ensure its success) comes from the impact on the domestic economy: increased competition induces firms to reduce their costs and improve

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

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

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

quality; domestic pricing of imports to reflect their foreign prices permits a more rational allocation of foreign exchange; and information flows about innovations and improved techniques abroad appear to increase greatly when trade policies are liberalized.

However, the benefits of trade liberalization are greater, the greater the access to markets in other countries domestic exporters have and the more rapidly the international economy is expanding. For, when there are few barriers to new entrants, those domestic producers who believe that they could profitably export are much more likely to take the risks involved in establishing new markets than when there are either trade barriers already in place or likely to be erected if exporters are successful.

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

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

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

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

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

What would be the Costs of Shifting to Regional Trading Blocs? Suppose that, instead of forming a trading arrangement that is GATT-plus, European, Asian and Western Hemisphere countries each form trading blocs. An important question is the consequences for the world trading system.

Answering the question precisely is difficult for a variety of reasons. Much of the assessment of the potential damage to developing countries depends on how one views the prospects for evolution of the world system once trading blocs have formed. The initial formation of trading blocs would presumably be

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

only the start of increasing trade friction, and trade barriers, between regions. If trade frictions mounted over time, one can imagine two outcomes: either each region would erect increasing barriers against imports from the other, or the costs of this outcome would be seen to be so great that representatives of the countries in the various region would find ways to reinstitute and strengthen the open, multilateral, trading system.

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

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

If, therefore, the world entered a period of increasing protectionism between regions, one could expect a rate of growth of world trade of less than 5 percent, while if instead the open multilateral trading system and trade

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

liberalization prevails, one might witness the return to 9-10 percent annual growth in the volume of world trade. For developing countries, slow growth of world trade would imply a no more rapid a rate of growth of exports than 6-7 percent annually¹², with the most successful countries experiencing growth rates between 10 and 15 percent. That contrasts with Korea's and Taiwan's 40 percent in the 1960s, and Turkey's 25 percent annual growth of exports in the 1980s. By contrast, if world trade and output, spurred by continuing trade liberalization, could resume the growth rates of the earlier decades, developing countries as a group could experience 9-10 percent growth rate of exports annually with little disruption of developed countries' markets.¹³ That would permit the high flyers among the developing countries to achieve growth rates similar to those of Korea and Turkey in earlier decades.

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

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

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

2. Economically Beneficial and Harmful Regional Arrangements

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

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

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

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

U.S. would increase 20 percent while the real costs of chemical imports to Mexico would increase 40 percent.

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

Most analyses of FTAs focus on potential trade diversion as the major cost of such an arrangement. However, there are other considerations which suggest that an FTA might have more negative effects than suggested simply by the sorts of direct trade diversion discussed above. One risk, in the case of Latin America, is that trade might initially be diverted from, say, Korea to Mexico when Mexico joins the FTA, and then diverted again from Mexico to Brazil when Brazil joins. To a degree, this is already happening with respect to the countries that became eligible for preferences under the Caribbean Basin Initiative (CBI): once it was known that the United States and Mexico would enter an FTA, some of the firms that had been induced to invest in the Caribbean countries because of CBI preferences shifted their activities to Mexico.¹⁵

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

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

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

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

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

Beneficial FTAs. No FTA is going to be entirely trade-diverting. The more a country's imports already originate with an FTA partner, and the lower its trade barriers prior to an FTA, the less costly is trade diversion likely to be.

There is no question, however, but that there are potential pitfalls of regional FTAs, although they can be avoided by unilateral trade liberalization.

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

The pitfalls of regional arrangements are also smaller, and the potential gains greater, when the potential entrant to an FTA already has very low levels of protection. Indeed, the ideal arrangement would be for a potential entrant to be practicing free trade, and to enter into an FTA with another country for purposes of achieving greater assurance of market access, and greater integration of markets, than can be achieved simply by removing all trade barriers.

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

Moreover, in circumstances where trade barriers are already very low, an FTA can serve as a "commitment" to investors that trade policies will remain liberalized. This can be an important source of gain for countries that have recently reformed their trade and payments regimes; a major source of difficulty

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

in the transition to an outer-oriented economy can arise if investors are hesitant because they fear that the newly liberalized trading regime will not persist. In those circumstances an FTA may accelerate and increase the benefits of an outer oriented trade strategy.

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

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

3. Assuring a Beneficial FTA.

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

A good starting point is to note that "natural trading partners" are potentially better members of an FTA than are those in which there are few (or, as in the extreme example, no) commodities that each is the low cost external

¹⁷See Rugman and Anderson (1987).

producer for the other. An FTA with the United States makes a great deal of sense for Mexico¹⁸, for example, because the United States is the low-cost source for about 70 percent of Mexico's imports in any event. Mexico in effect reduces her tariffs and quantitative restrictions on imports from her low cost source and in addition benefits from reduced U.S. trade barriers to American imports from Mexico. Mexico's tariff rates are also very low, which means that there can be few items for which the regional preference shifts sources to the U.S. because of the margin of the tariff.¹⁹

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

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

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

However, the extent to which an FTA does this depends both on the extent to which it is GATT-plus (rather than a move away from the multilateral trading system toward trading blocs) and on some technical aspects of the agreement. It is to these latter that we now turn. Several items need to be considered: 1) the extent to which all members of an FTA are on an equal footing and potential entrants may join; 2) the degree to which the arrangement is a uniform-across-the-board agreement, as contrasted with sector-specific arrangements; 3) the restrictiveness of rules of origin; and 4) the extent to which the agreement provides protection against "administered protection" and other non-tariff trade barriers. Each of these is briefly discussed in turn.

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

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

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

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

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

This trade and investment diversion has already been a source of concern for the Caribbean countries.²² The United States extended unilateral duty-free preferences to those countries (over and above GSP treatment) in 1983, and factories were subsequently built to take advantage of that status. When the negotiations for an FTA with Mexico were announced, the beneficiaries of Caribbean Basin Initiative preferences protested, and several potential foreign investors shifted to Mexico in anticipation of the new FTA. If, as anticipated, Mexico forms an FTA with the United States and thereby induces additional investment in some export industries, Mexico will be at risk that some lower-cost

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

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

source will subsequently form an FTA and divert trade and production. This would not only constitute a waste of resources, but also lead to misunderstandings unless it is recognized in advance that new members will accede to the FTA on similar terms.²³

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

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

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

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

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

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

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

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

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

that there should be as much across-the-board, and as little sectoral, arrangements as possible.

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

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

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

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

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

The Canada-U.S. agreement contained clauses which provided some insulation for Canadian producers, and a joint tribunal for deciding upon cases in which

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

there were disputes. It will be desirable to extend these mechanisms multilaterally across members of WHFTA for three reasons. First, those mechanisms are already in place. Second, there is considerable potential for confusion if rulings by different dispute resolution panels are different. Third, a multilateral dispute resolution mechanism will provide a counterweight to the United States which has considerably greater bargaining power vis-a-vis any individual country than it does vis-a-vis all other members of a WHFTA.

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

4. Domestic Economic Policies Compatible with an FTA.

All of the issues discussed above are subject to negotiation at the time of entry to an FTA and as such, are not entirely subject to the wishes of Latin American participants. Bargaining by its nature must entail some giving in on issues of importance by both parties. While Latin American countries should weigh the desirability of across-the-board arrangements, open accession provisions, liberal rules of origin, and a flexible dispute settlement mechanism heavily in deciding upon their negotiating stance, they do not themselves have control over the precise form of a WHFTA.

By contrast, they can alter their domestic economic policies in ways which are conducive to greater gains from trade and provide at least some protection against possible inefficiencies that might arise from trade diversion under an FTA. Two sets of economic policies require attention: 1) the consistency of

overall macroeconomic and exchange rate policy; and 2) the openness of the potential FTA member's overall trade regime. In this section we consider each in turn.

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

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

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

competitive pressure, while exportable industries face insufficient incentives for expansion.

Once an FTA is in place with a realistic exchange rate, either exchange-rate (and interest rate) policy must compensate for inflation differentials or domestic macroeconomic policy must assure a domestic rate of inflation very close to that of partner countries.²⁶ Because imports may enter from the partner country freely, a small difference in inflation rates at a fixed nominal exchange rate can lead to large shifts in demand between domestic and foreign producers. The world was given a dramatic view of the importance of exchange rate policy when the Germans adopted an exchange-rate for unification that left almost all firms in the east unable to cover even marginal costs at west German prices and the chosen exchange rate.²⁷ The same effects will occur between any new entrant to a WHFTA and the U.S. and Canada should exchange rates initially be incompatible with the current price and cost structure in the partner countries. Even if they are compatible, it will be essential that they stay that way, and this will require either convergence of inflation rates or very quick adjustment of the exchange rate to inflation differentials.²⁸

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

²⁷See Akerlof et.al., 1991.

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

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

Hence, not only exchange rate, but also interest rate, policy must be firmly based on realistic expectations about domestic monetary and fiscal policy. Since all policy makers tend to err in the direction of optimism, it is probably desirable that countries joining an FTA initially opt for a crawling peg exchange rate, where it is expected that adjustments will cover inflation costs differentials and may in addition be used to bring the real exchange rate to a realistic level, and for an interest rate regime consistent with anticipated inflation and exchange rate behavior. Then, when domestic macroeconomic policy

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

has achieved convergence of inflation rates, a crawling peg can, first de facto, and then de jure, become a fixed exchange rate regime.

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

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

A first prerequisite of an FTA is a consistent set of exchange rate, macroeconomic, and interest rate, policies. That insures that gains are possible, and that avoidable damage to domestic production and employment will not occur. The second prerequisite is removal of trade barriers, which again insures that trade diversion will be minimal and that membership in the FTA will be consistent with an overall outward oriented trade policy. That in itself is, of course, growth-promoting. This last set of policies regarding infrastructure is not, strictly speaking, necessary to FTA membership, but it certainly affects the size of the gains that can be realized from a more outward orientation and FTA membership. There is little benefit from exporters realizing lower costs if their shipments will be detained for unpredictable and variable periods of time by delays in domestic transport or at port. Reliability and speed of communications

between suppliers and buyers are essential for success in selling most modern industrial goods. Similarly, a 10 percent reduction in the costs of domestic shipping can be more valuable to potential exporters than a change in the real exchange rate, affecting as it would both their costs of inputs and their receipts from exports.

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

5. Negotiating an FTA from a Latin American Perspective.

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

As the discussion of the preceding sections makes clear, Latin American countries that have already liberalized their trade regimes and have stabilized their macroeconomic and exchange rate policies will stand to gain the most from joining a WHFTA. Trade liberalization takes priority: if macroeconomic stabilization is taking place gradually, a consistent crawling peg exchange rate policy can enable an FTA to provide gains even as macroeconomic stabilization

proceeds; by contrast, without prior trade liberalization, the adjustment costs of an FTA will be greater and in addition the potential for trade diversion once an FTA is formed will be greater. Moreover, countries that have liberalized their trade regimes will themselves have fewer pressure groups seeking exemption from the FTA if they have already liberalized their economies. That, in turn, will permit a stronger negotiating position vis-a-vis pressures for negotiation on a sector-by-sector basis from other FTA members. In regards to all economic policy measures, it is important that all economic policies immediately be based in part on avoiding measures that will build in any more special interests that might oppose an FTA.

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

It is in the long-run interests of all Latin American countries that a WHFTA be open, and accessible to new entrants on roughly the same terms as existing members have entered. It is in this connection that regional unity may well permit a better result for all than would bargaining on an individual basis for particular terms for each country.

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

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

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