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A Western Hemisphere Free Trade Area: An Overview of the Issues

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Contents

Introduction	iii
I. Global Issues	1
I.1. Rationale for a WHFTA	
I.2. The International Context	
I.3. Lessons from the GATT and other Multilateral Trade Liberalization Agreements	
II. Trade Liberalization Arrangements in the Western Hemisphere	2
II.1. U.S.- Canada FTA, and NAFTA negotiations	
II.2. Other Sub-regional Integration Schemes	
III. Cost-Benefit Analyses at Country & Sectoral Level	3
III.1. Country Case Studies: A Typology	
III.2. Sectoral Impact Across Countries	
III.3. Empirical Models	
IV. The Negotiating Agenda and Perspectives	4
IV.1. Market Access	
IV.2. Rules of Origin	
IV.3. Domestic Trade Remedies	
IV.4. Dispute Settlement	
IV.5. Trade-related Investment Measures	
IV.6. Trade-related Intellectual Property Rights	
IV.7. Environment and Trade	
IV.8. Labor	
IV.9. Business	
V. The Transition	7
V.1. Different Approaches	
V.2. Domestic Requirements and Complementary Policies	
V.3. Institutional Aspects	

Introduction

This paper outlines issues to be covered by the study of hemispheric trade liberalization, particularly those raised by the proposal to establish a Western Hemisphere Free Trade Area (WHFTA). The objective is to provide a framework for an enlightening dialogue on hemispheric trade liberalization and on the trade component of the Enterprise for the Americas Initiative (EAI).

The Initiative has come at a time when several important global events will have direct bearing on its potential outcome. For instance, the Uruguay Round negotiations of the GATT remain unresolved, although there seems to be a consensus that failure to conclude the talks satisfactorily would place the global multilateral trading system in jeopardy.

Closer to home, the NAFTA talks will likely serve as the basis for further negotiations, even if they stretch out longer than initially anticipated. Finally, recessionary trends furnish the background for the degree of support that trade liberalization will generate in the short run, in view of anticipated higher unemployment.

The IDB-ECLAC project aims to enhance the dialogue on hemispheric trade liberalization. Mutually beneficial negotiations will require frank analysis of the issues.

What follows is an outline of the issues that need to be addressed when considering the formation of a WHFTA. They are grouped under five major headings: (1) global issues, (2) trade liberalization in the Western Hemisphere, (3) estimated impact from trade liberalization at country and sector levels, (4) negotiating agenda and perspectives, and (5) the transition. Throughout the five headings, the focus is on the costs and benefits of a WHFTA (globally, regionally, by country, by sector, and also by negotiating topic), as well as on practical considerations relevant to a process of hemispheric trade liberalization. Annex I contains the list of topics to be covered under each of the five major headings.

I. Global Issues

The textbook definition of a free trade area (FTA) is straightforward. It is a form of economic integration where all trade barriers are removed among member countries, while each member retains its own trade policies with nonmembers. Yet, the modalities that an FTA can adopt and the means to implement it can be complex. An FTA can take on many shapes since the pace and scope of the trade liberalization process can vary substantially. In particular, the number and diversity of countries involved in an FTA impose unique considerations concerning the potential distribution of gains and losses. Moreover, since costs and benefits vary by country and by sector, a trade liberalization process can be expected to be complex, and sorting out the repercussions of a WHFTA, given the current global context, will prove to be challenging.

I.1. Rationale for a WHFTA

The first item that needs to be addressed is the rationale for a WHFTA. This entails consideration of current and future trading options open to Latin America and the Caribbean, and whether it is in the interest of the region to pursue the establishment of a hemispheric FTA. Arguments to be explored include, for instance, the extent to which the region can gain access to the U.S.-Canadian market, and the effect of an FTA agreement on current domestic economic reforms. Proponents of hemispheric trade liberalization often argue that an FTA can effectively serve to "lock in" domestic policy reforms and provide an insurance policy against policy retrogression. A more skeptical outlook points to the constraints on domestic policy making that result from a foreign trade pact. Anticipated benefits and costs -- the extent of trade creation and trade diversion, static and dynamic effects, as well as short- and long-run gains and losses -- must also be taken into account.

I.2. The International Context

Global implications of a WHFTA that need to be studied include its effect on the multilateral trading system and other trends elsewhere toward regional integration. Some argue that, given the complexity of present multilateral trade negotiations, the pursuit of regional agreements could be the only remaining means to achieve a more liberal trading environment. It is further argued that a WHFTA could serve as a catalyst toward liberalizing trade between regions. The prospect of a hemispheric free trade arrangement could offer sufficient inducement to persuade other regions to accelerate the process of multilateral liberaliza-

tion. Others argue, by contrast, that the outcome could be the division of the world trading system into regional blocks.

I.3. Lessons from the GATT and other Multilateral Trade Liberalization Agreements

Finally, this section includes lessons from trade liberalization agreements beyond the hemispheric boundaries. Lessons should be derived from the current Uruguay Round negotiations, as well as how to make a WHFTA "GATT compatible."

Much can be learned, also, from an examination of the European Community's experience of economic integration and the way it has incorporated less-developed countries into the process. European economic cooperation has evolved over many years and interesting lessons could be drawn from the pace at which it has proceeded. Other trade pacts such as the U.S.-Israel FTA agreement may provide valuable lessons for the study of hemispheric trade liberalization.

II. Trade Liberalization Arrangements in the Western Hemisphere

The second major area of interest is the existing trade liberalization arrangements and current negotiations in the Western Hemisphere, including the Canada-U.S. FTA agreement, the NAFTA negotiations, CARICOM, MERCOSUR, CBI, CACM, ALADI, and the Andean Pact. Relevant lessons can be learned, in particular from the Canada-U.S. agreement, and the likely impact of the formation of a WHFTA on these subregional agreements can be assessed and the relationship between them and the prospective WHFTA considered. An assessment of the status of trade reforms and an inventory of trade barriers between hemispheric country groups would also prove helpful.

II.1. U.S.-Canada FTA agreement and NAFTA negotiations

The U.S.-Canada FTA and the NAFTA negotiations merit particular scrutiny, since future negotiations between other Latin American and Caribbean countries and North America are likely to be affected substantially by these

precedents. In fact, NAFTA could serve as the vehicle through which the Latin American and Caribbean countries enter into a hemispheric agreement since it could incorporate a set of standard requirements or a "docking clause" through which interested countries or groups of countries can gain access.

An assessment of the major issues on the negotiating table, the major sources of contention, the disputes that were resolved and those that remained unresolved, and the implications of these issues on future hemispheric negotiations has the potential to be a very productive exercise. It would also be illuminating to undertake preliminary assessment of the repercussions in Canada and the U.S. of the 1989 trade liberalization pact.

II.2. Other Subregional Integration Schemes

Of fundamental importance for existing subregional economic cooperation schemes is an assessment of how these systems will be affected by hemispheric trade liberalization. One scenario is for the Enterprise for the Americas Initiative, whether or not it ultimately results in a WHFTA, to serve as the catalyst for greater economic integration.

A crucial issue to consider is the possible role of subregional integration schemes in the establishment of a WHFTA. The existing institutional frameworks and liberalization schemes could be used to bring about a WHFTA.

III. Cost-Benefit Analyses at the Country and Sectoral Levels

The third major area of study involves assessing costs and benefits at the country and sector levels. As it will not be possible to examine all countries in the Western Hemisphere, an attempt will be made to develop a typology of countries based, for example, on common characteristics such as size (focusing particularly on the small countries), degree of openness, and structure and concentration of trade with the U.S. Countries that typify these categories would be analyzed.

Costs and benefits would be examined for a representative country in each group. Effects on employment, on trade and investment, on productivity, on technology transfer, and, ultimately, on overall economic growth should be included.

The economic analysis should also consider the impact of trade liberalization by sector (agriculture, industry, services, and energy), since effects will differ between sectors. It will be useful to analyze particular sectors across countries as well.

As part of this exercise, it would be helpful and practical to survey existing empirical models for estimating the impact of trade liberalization, in particular those developed for use with the NAFTA countries.

IV. The Negotiating Agenda and Perspectives

The purpose of this section is to anticipate issues likely to be included in the negotiations and clarify those that could be the most contentious. To this end, the perspectives and anticipated roles of particular groups such as labor and business will need to be addressed.

The issues currently negotiated in NAFTA provide the basis to anticipate a plausible agenda to negotiate a WHFTA. These topics include (1) market access, (2) rules of origin, (3) domestic trade remedies, (4) mechanisms for dispute settlement, (5) trade-related investment measures, (6) trade-related intellectual property rights, (7) the environment, (8) labor, and (9) the role and perspectives of business throughout the hemisphere.

IV.1. Market Access

A WHFTA will very likely require the immediate or phased elimination of all tariffs as well as the reduction of nontariff trade barriers among the countries. The key issue in this process is how to maximize the benefits of liberalization and minimize the cost of adjustment of sensitive sectors.

It will be important to anticipate the repercussions of liberalization at the sector level. In agriculture, for example, this implies anticipating which commodities would be included and which would remain off-limits. Given the great importance of rural institutions and markets, an examination of the impact of trade liberalization on them is essential. This study must identify types of adjustment programs that will mitigate adverse distributional consequences.

Beyond agriculture, manufacturing industries such as textiles and steel may require special analysis. Trade in automobiles is becoming one of the key issues within the NAFTA talks and will probably be as important in any WHFTA.

Trade in services has already demonstrated its relevance within the Uruguay Round and can be expected to be important in the WHFTA negotiations as well. Safeguards, a time-frame for implementation, and preferential status for financial services, insurance, and telecommunications figured prominently in the NAFTA negotiations. The tabulation and analysis of trade policies and trade barriers by country throughout the region will be an important exercise.

IV.2. Rules of Origin

Rules of origin determine market access for products that have components produced both within and outside the FTA. These regulations have decisive repercussions on trading relations between members and nonmembers, on trade creation and diversion, as well as on investment flows.

There are several ways to calculate the rules (for example, tariff classification changes versus minimum regional value-of-content criteria), as well as differences of opinion as to the best methodology. Agreement on these rules can be very complex.

IV.3. Domestic Trade Remedies

Domestic measures to apply trade remedies need to be carefully studied. The bulk of these unilateral decisions are often referred to as safeguard mechanisms -- "escape clauses," antidumping and countervailing duties, extended unemployment benefits, and capital adjustment incentives -- which should facilitate the adjustment process to trade liberalization. In some cases, however, safeguards or safeguard-like measures may impede the adjustment process.

A dilemma has to be resolved on safeguards. On the one hand, stringent safeguards will help ensure domestic political support. On the other, limiting the application of safeguards may provoke the use of more onerous forms of protection that ultimately defeat the purpose of the trade liberalization.

IV.4. Dispute Settlement

The issue of trade remedies makes evident the need to arbitrate disputes via concerted settlement mechanisms. The study of such mechanisms is imperative in any dialogue on the establishment of a WHFTA. It should focus on precedents (including the U.S.-Canada FTA, the EC, and the GATT), the coexistence of different legal and administrative systems, and the design of a common, hemispheric system for settlement of disputes.

IV.5. Trade-related Investment Measures (TRIMS)

The main issues relate to foreign investment restrictions levied in the host country. The most restrictive rules pertain to local-content requirements (some minimum percentage of inputs of the foreign company must be purchased locally), export performance (some percentage of the foreign company's product must be exported), and foreign exchange generation (foreign companies may have to provide foreign exchange themselves via exporting).

Many supporters of a WHFTA have argued that the dynamic benefits from investment flows generated by trade liberalization are contingent on the extent of restrictions on these flows.

IV.6. Trade-related Intellectual Property Rights (TRIPS)

Many U.S. producers complain that their intellectual property rights (such as trademarks and patents) are violated in foreign markets, particularly in developing countries. Latin American countries are also finding themselves harmed by lax laws, since their own products are being copied without license.

More fundamental than the length of patent protection is what should be the basic negotiating approach: there should be either a single, comprehensive agreement for the hemisphere or several flexible arrangements that provide for greater discretion.

IV.7. Environment and Trade

Even though a hemispheric free trade area will not become a reality in the short term, it is important to incorporate environmental issues related to international trade into the dialogue.

A preview of what lies ahead may be the "tuna dispute" between Mexico and the United States. In this vein, there is a need to shed light on existing mechanisms in international law and ongoing trade negotiations that can minimize environmental conflicts. It is essential to identify the mechanisms that exist now or are being proposed to facilitate trade liberalization and also protect the environment. There is also a need to assess the potential environmental effects of trade liberalization, and to ascertain the position and possible role of environmental groups.

IV.8. Labor

As with the environment, labor issues related to trade have been growing in importance in trade negotiations, particularly in NAFTA. The reason stems in large part from the differences in wages and policies between Mexico and the United States and Canada. Worker health and safety standards, child labor laws, and worker rights such as the establishment of unions will also require consideration.

The relative lack of enforcement of standards has been described as a form of social dumping. One concern heard from labor groups in the United States, for example, is that free trade may equalize living standards between trading partners in WHFTA by pulling U.S. workers down to a lower level to be able to compete.

IV.9. Business

Finally, it should also prove enlightening to analyze the role and perspective of business groups and organizations, since their role as operator is crucial in the implementation of any trade liberalization process.

V. The Transition

Finally, the fifth major area encompasses the requirements to establish and maintain a WHFTA. This includes an assessment of the different alternatives for the attainment of hemispheric trade liberalization, as well as the preconditions and policies needed to accompany the trade liberalization process, particularly the institutional aspects.

V.1. Different Approaches

Two polar models for the establishment of an FTA can be identified. First, the "hub-and-spoke" model refers to one country (the hub, which in this instance, would be the United States) engaging in a series of bilateral FTA agreements with other countries of the region (the spokes). This approach suffers from a number of deficiencies. It would confer superior bargaining to the hub and cause trade and investment flows to be diverted between the spokes.

Nevertheless, the hub-and-spoke approach may be more feasible than its polar alternative: "plurilateral" liberalization. This approach refers to an agreement by which all the participants have some obligations and privileges within a common framework agreement of rules valid for all member countries.

In between the two pure cases may be found some hybrid options. For example, a modified hub-and-spoke in which the spokes would consist of different subregional integration schemes. The feasibility and desirability of these options and others need to be explored.

A related requirement has to do with the actual structure of the agreement(s). Some have suggested that there should be one fundamental agreement to which countries can subscribe when they are ready to do so. Several variations are possible within this framework. For example, there may be justification for grouping the countries of the region (for example, according to level of development) so that some would need more stringent or faster liberalization conditions than others. Another possibility is for all participants to accept a core agreement, with due allowance to be agreed upon separately for special circumstances in individual countries.

V.2. Domestic Requirements and Complementary Policies

These requirements and policies refer to public and private actions needed to ensure that net gains from trade liberalization are maximized and sustained. This involves macro- and microeconomic steps focusing on possible adjustment mechanisms or means to compensate those who might otherwise lose from trade liberalization.

Macroeconomic considerations would include some domestic prerequisites such as the need to control inflation and stabilize the economy, and further advance in structural reforms. Another crucial macroeconomic consideration has to do with exchange rates and exchange rate policies, since trade liberalization

might cause pressure to fix exchange rates. The repercussions of this outcome need to be discussed.

Microeconomic considerations might include efforts to overcome export constraints and infrastructure bottlenecks. Many of these efforts include practical, common-sense measures and merit explicit attention. In particular, the role of industrial policy merits examination.

In addition, identification is needed of creative and feasible means to enfranchise as many people as possible in the gains from freer trade. There exists a strong theoretical and empirical consensus among economists that the aggregate gains from trade liberalization tend to outweigh the losses. One fundamental issue, then, is to devise mechanisms to spread the gains to those who might otherwise lose. This makes sense on both ethical and political grounds.

Germane to all these policies is the issue of timing and proper sequencing of policies. Consideration needs to be given to the desired and feasible order of events, particularly to finding out if there is an optimal way.

V.3. Institutional Aspects

Finally, critical in any study of a WHFTA are the practical institutional considerations focusing on an exploration of possible alternatives (existing and/or new) that might fulfill the required functions. Some of these functions include a clearinghouse mechanism for information and research, training and advisory services, and conflict resolution mechanisms. One way to explore institutional alternatives would be to examine institutional precedents. This might include, for example, the study of experiences such as that of the EC-Lomé negotiations, the tripartite secretariat formed by the OAS, the IDB, and ECLAC to implement the Alliance for Progress, as well as the functioning of existing mechanisms such as the OAS Special Commission for Consultations and Negotiation (CECON, in Spanish).

ANNEX I

List of Topics: IDB-ECLAC Hemispheric Trade Liberalization Project

I. Global Issues

- (1) An Overview of the Prospects and Implications for a WHFTA in Global Context
- (2) Rationale for a WHFTA in Global Context
- (3) WHFTA, Regional Trading Blocs, and the Multilateral Trading System
- (4) Conditions for Maximizing the Gains from a WHFTA in Global Context
- (5) The Impact of WHFTA on Hemispheric Relations
 - (a) WHFTA and Europe
 - (b) WHFTA and East Asia
- (6) Lessons from Trade Liberalization Experiences
 - (a) East Asia
 - (b) EC
 - (c) GATT
 - (d) Israel-U.S. FTA

II. Trade Liberalization Arrangements in the Western Hemisphere

- (1) Hemispheric Lessons from US-Canada FTA and NAFTA
- (2) Roles of and Impacts on Hemispheric Sub-regional Integration Systems
 - (a) CACM

- (b) CBI
- (c) Andean Pact
- (d) Mercosur
- (e) ALADI
- (f) CARICOM

(3) Regional Integration and Integrated Regional Production

III. Estimated Costs and Benefits From Hemispheric Trade Liberalization at Country and Sectoral Level

(1) Country Case Studies. The countries will be drawn from the following typology:

- (a) Trade structure by sector: manufactures, agriculture, energy
- (b) Size of economy: small-large
- (c) Trade regime: open-closed

(2) Sectoral Impact: how WHFTA will affect the following sectors across countries:

- (a) Industry: computers, autos, textiles and apparel
- (b) Natural Resources: agriculture, fisheries, oil
- (c) Services

(3) Cost-Benefit Empirical Models: Review & Analysis

IV. The Negotiating Agenda and Perspectives

(1) Market Access: Tariffs and NTBs

- (2) Hemispheric Trade Policy & Reforms
- (3) Trade in Services
- (4) Rules of Origin
- (5) Domestic Trade Remedies
- (6) Dispute Settlement
- (7) Trade-Related Investment
- (8) Intellectual Property Rights
- (9) Environment
- (10) Labor
- (11) Business

V. The Transition

- (1) Alternative Negotiating Models
- (2) Macroeconomic Domestic Policies to Accompany Trade Liberalization
 - (a) Stabilization Policies
 - (b) Financial Liberalization
 - (c) Role of Exchange Rates
 - (d) Policy Sequencing
- (3) Microeconomic Domestic Policies to Accompany Trade Liberalization
 - (a) Role of Government and Private Sector in Promotion of Exports
 - (b) Industrial Policy
- (4) Institutional Mechanisms to Bring About and Sustain a WHFTA

(a) Institutional Precedents

(i) CECON

(ii) Experiences of EC-Lome Negotiations

(iii) Tripartite Secretariat of the Alliance for Progress

(b) Role of Existing International Institutions

(c) Role of New Institutions

